



MAJOR FINANCIAL CRISIS - FROM GREAT DEPRESSION TO GREAT RECESSION

World Economic History



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WORLD ECONOMIC HISTORY: MAJOR FINANCIAL CRISIS

FROM GREAT DEPRESSION TO GREAT RECESSION

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This paper is dedicated to the doyens of Indian Banking, Dr. M.Narasimham, Dr. C.Rangarajan, Dr. Bimal Jalan, Dr. Y.V.Reddy and Dr. Duvvuri Subbarao. These great men handled the macroeconomic policies of the Nation as Governors of the Reserve Bank of India with steely resolve and foresight steering the Nation's economy through many turbulent waters while the world economy weathered a number of storms.

Abstract: Economic histories of Nations contain several success stories of economic reforms undertaken by them, but what are remembered most are the years of hardship suffered by millions of populations at times of economic crisis. Thankfully the global efforts for addressing financial crisis have proved largely successful despite the severe temporary hardships imposed on the population. Some of the largest financial crisis of the 21st Century were witnessed in Argentina, Brazil, Turkey, European Union – Greece, and the World Economic Crisis in 2008. Argentina's currency crisis was so severe that the Washington Post reported that parts of the country went back to the barter system. The G7 Finance Ministers with the IMF and World Bank formulated lending policies to enable crisis-ridden countries to regain macroeconomic stability. The lecture on World Economic History - Major Financial Crisis will cover 8 major financial crisis that the world witnessed in the last 100 years. The 8 crises that will be presented are the Great Depression 1932; the Suez Crisis 1956; the International Debt Crisis 1982; the East Asian Economic Crisis 1997-2001; the Russian Economic Crisis 1992-97, the Latin American Debt Crisis in Mexico, Brazil and Argentina 1994-2002, and the Global Economic Recession 2007-09.

Large macroeconomic imbalances represented by current account deficit and fiscal deficit contributed to vulnerability in Emerging Market Economies (EMEs). In most crisis countries, EME's financed the twin deficits with short-term foreign currency debts. A financial crisis driven by excessive loan growth was normally preceded by currency crisis, high inflation and debt defaults resulting in high capital outflows. Financial crisis also resulted from poor banking regulation, explicit government guarantees resulting in macroeconomic distortions to promote excessive investment and external shocks like commodity price volatility deteriorated a country's terms of trade. The Great Depression of 1930-31 and the Great Recession of 2007-08 were episodes in which a large number of countries simultaneously experienced crisis. The other 8 cases are largely country specific crisis. The global crisis and national crisis were preceded by elevated growth rates and collapses in the year of financial turmoil.

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Major Financial Crisis: From Great Depression to the Great Recession



V.Srinivas¹²

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At the outset, let me thank the Director General National Archives of India for inviting me to deliver this special lecture on World Economic History - Major Financial Crisis: From Great Depression to Great Recession.

My years (2003-2006) on the Executive Board of the International Monetary Fund, coincided with some of the largest financial crisis of the 21st Century. Argentina, Brazil and Turkey were the Emerging Market Economies, which were witnessing severe financial crisis. Argentina's currency crisis was so severe that the Washington Post reported that parts of the country went back to the barter system. The G7 Finance Ministers with the IMF and World Bank formulated lending policies to enable crisis-ridden countries to regain macroeconomic stability. The work I had undertaken in that period, inspired me to pursue a study on the major financial crisis of the 21st century. The 8 crises that I will be presenting to in this lecture are the Great Depression 1932; the Suez Crisis 1956; the International Debt Crisis 1982; the East Asian Economic Crisis 1997-2001; the Russian Economic Crisis 1992-97, the Latin American Debt Crisis in Mexico, Brazil and Argentina 1994-2002, and the Global Economic Recession 2007-09.

INTRODUCTION

Large macroeconomic imbalances represented by current account deficit and fiscal deficit contributed to vulnerability in Emerging Market Economies (EMEs). In most crisis countries, EME's financed the twin deficits with short-term foreign currency debts. A financial crisis driven by excessive loan growth was normally preceded by currency crisis, high inflation and debt defaults resulting in high capital outflows. Financial crisis also resulted from poor banking regulation, explicit government guarantees resulting in macroeconomic distortions to promote excessive investment and external shocks like commodity price volatility deteriorated a country's terms of

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trade. The Great Depression, the Suez Crisis, the International Debt Crisis, the East Asian Crisis, the Latin American Debt Crisis and the Great Recession were episodes in which a large number of countries simultaneously experienced crisis. In each instance, the global crisis was preceded by elevated growth rates and collapses in the year of financial turmoil.

The October 1929 crash of the US stock market was in the backdrop of a euphoric run-up of stock market prices. The bad recession of 1929 turned into the Great Depression of 1931 following a series of banking panics which emanated from Central Europe spreading contagion to the United Kingdom, the United States of America and France eventually engulfing the whole world. In the inter-war period the United States was running a significant current account surplus and Germany a significant current account deficit. Public and private sectors of Germany borrowed in dollar denominated bonds and credits from United States. The German credit boom was financed through a complex web of linkages in which banks of Germany, the Netherlands and Switzerland were involved. The German Central Bank – The Reichsbank did not provide adequate credit guarantees and credit risks were not covered. The financial crisis occurred in parallel in German and Swiss Banks and the resultant capital flight set off a banking sector crisis.

Egypt's nationalization of the Suez Canal in 1956 and the failed attempt to recapture it by France, Israel and United Kingdom had significant economic consequences resulting in all four countries seeking IMF financial assistance. The military action lasted two months and in the midst of the turmoil and uncertainty, a financial crisis erupted. The pound sterling came under heavy speculative pressure and United Kingdom witnessed short-term capital outflows.

The international debt crisis began on August 20, 1982 when the Mexican Finance Minister informed the bankers assembled in New York that Mexico could not repay the loan that was due and engulfed 20 countries. At the same time, Europe's commercial banks, which had a significant exposure to Poland, were informed of the need for rescheduling the terms of repayment. Similar requests were received from Romania, Hungary and Yugoslavia. The monetary contraction in the United States in the 1970-80 period resulted in a sustained appreciation of the US dollar. It made repayments in dollar terms impossibly difficult for most countries of Eastern Europe and Latin America. The commercial debt crisis erupted in 1982 and lasted till 1989.

A major financial crisis struck many East Asian countries in 1997. The East Asian economies, which were witnessing rapid growth and improvement in living standards suddenly, got embroiled in a severe financial crisis. The crisis was largely a result of large external deficits, inflated property and stock market values, poor prudential regulation, lack of supervision and exchange rate pegs to the US dollar resulting in wide swings to the exchange rates making international competitiveness unsustainable.

In August 1998 Russian Federation declared a default on its debts. There were difficulties in reaching a coherent rescue plan. The banking system paralyzed, the asset prices crashed, investors fled and millions of families plunged into poverty.

The Latin American Debt Crisis occurred a number of times, in the 200 year history of the Continent. This lecture covers the crisis witnessed in Mexico in 1994-95, Brazil in 1999-2003 and Argentina in 2001-02. The Tequila crisis of Mexico 1994-95 required a US \$ 17.8 billion stabilization program from IMF, the Brazilian crisis required a stabilization program of US \$ 18 billion largely preventive in nature. The worst episode was Argentina. In 2001-02, Argentina experienced one of the worst economic crisis in its history, with a 20 percent fall in output growth over 3 years, high inflation, government defaults on debt and a banking system paralyzed.

The 2007 Global Financial Crisis began as a sub-prime crisis, spread to a number of economies through a combination of direct exposures to sub-prime assets. It resulted in a gradual loss of confidence in a number of asset classes and drying up of wholesale financial markets. It exposed the financial imbalances in a number of advanced economies, which had an over-reliance on funding sources by banking systems and asset bubbles in residential property markets. The Global Financial Crisis required significant international policy cooperation with the G7 group of countries expanding to work with the G20 member countries to address the challenges of global imbalances.

Economic histories of Nations contain several success stories of economic reforms undertaken by them, but what are remembered most are the years of hardship suffered by millions of populations at times of economic crisis. Thankfully the global efforts for addressing financial crisis have proved largely successful despite the severe temporary hardships imposed on the population.

THE GREAT DEPRESSION

On October 25, 1929 the New York Stock Exchange saw 13 million shares being sold in panic selling. During the 1920s the American economy grew at 42 percent and stock market values had increased by 218 percent from 1922 to 1929 at a rate of 20 percent a year for 7 years. No country had ever experienced such a run-up of stock prices which attracted millions of Americans into financial speculation. Nobody had seen the stock market crash coming and Americans believed in permanent prosperity till it happened. There was no rational explanation for the collapse of the American markets in October 1929. Nearly US \$ 30 billion were lost in a day, wiping out thousands of investors. In the aftermath of the US stock market crash, a series of bank panics emanated from Europe in 1931 spreading financial contagion to United States, United Kingdom, France and eventually the whole world spiraled downward into the Great Depression. The Great Depression lasted from 1929 to 1939 and was the worst economic downturn in history. By 1933, 15 million Americans were unemployed, 20,000 companies went bankrupt and a majority of American banks failed.

Early in 1928, the US Federal Reserve began a monetary contraction to reduce stock market speculation. This coupled with declining value of bank assets resulted in a rush of bank withdrawals. As Americans held onto liquidity, the ability of the Banking system to generate money through deposits was curtailed. The US Banking

system could have been saved by a massive recapitalization of Banks but the Federal Reserve did not intervene. In that period, the United States maintained significant current account surplus and Germany a substantial current account deficit. Borrowings by German public and private sector occurred in foreign currencies through dollar denominated bonds and credits from United States, routed through banks in the Netherlands, Switzerland and Austria. Monetary contraction in the United States culminated in a depression in Germany. The Reichsbank's foreign reserves of gold and foreign exchange declined sharply. In May 1931, Austria's largest Bank, the Kreditanstalt collapsed. As investors feared that their moneys would be frozen or lost, there was a huge capital exodus. Germany failed to obtain the foreign credits needed to halt the crisis. To halt the capital outflow, Germany had to close banks, devalue the mark, negotiate standstill agreements with foreign creditors and impose exchange controls. In the period 1930-32, money supply in the United States fell by 26 percent, Germany by 27 percent, in United Kingdom and France by 18 percent.

The German currency and banking crisis impacted the British pound. Vulnerabilities emerged in the British economy, given the United Kingdom's large short term indebtedness and slim gold reserves. European Banks whose assets were frozen by the German standstill agreements were making significant withdrawals from the United Kingdom resulting in a weakening of the pound. On September 16, 1931 United Kingdom suspended gold convertibility and allowed the pound to float. The Bank of England revalued its gold stock and expanded its domestic credit enabling a faster recovery than in United States and Germany. France felt the impact of the Great Depression once the pound became a floating currency and the dollar devalued. The French Franc was forced off the gold standard in 1936.

By 1933, 35 Nations had abandoned gold and gold-exchange standards. The trade of countries with stable currencies – France, Germany and United States declined substantially higher than the trade of countries with depreciated currencies – the United Kingdom and Canada. The decreases in value of exports in 1932 from the previous year was 35 percent in France, 40 percent in Germany and 33 percent in the United States as compared to 7 percent in United Kingdom and 19 percent in Canada. It was broadly felt that currency depreciation would stimulate a country's exports if other conditions are favorable. The United States promulgated the Tariff Act authorizing the President to raise or lower tariff rate by a maximum of 50 percent to ensure that the foreign currency depreciation did not result in millions of Americans losing their employment.

The United States did not lead the recovery in 1933. Economic recovery as indicated by industrial activity was visible in Great Britain, France and Germany, with the United States witnessing a rapid industrial upturn during April and May 1933. The "New Deal" of President Franklin Roosevelt brought in a sweeping reformation of the

US economy, laying the foundations of the American welfare state – federal aid to the unemployed, stiffer regulation of industry, legal protections for workers, and the Social Security program. The “New Deal” was the first step in the United States muscular emergence from the Great Depression, and the beginning of the country’s rise to become the undisputed “leader of the free world.”

THE SUEZ CRISIS

On July 26, 1956, Egypt nationalized the Suez Canal Company and assumed control of the canal from the international consortium that had run it for nearly a century. France, Israel and United Kingdom initiated joint military action, with Israel invading the Sinai on October 29, 1956. The military action lasted two months and in the midst of the turmoil and uncertainty, a financial crisis erupted. Egypt’s nationalization of the Suez Canal in 1956 and the failed attempt to recapture it by France, Israel and United Kingdom had significant economic consequences resulting in all four countries seeking IMF financial assistance. It also had a lot of political consequences, Egypt’s independence, Israel’s survival as a Nation, and a devastating blow to Britain’s Victorian aspirations. The Suez Canal was closed for 6 months resulting in trade diversion, cost increases and delivery delays impacting the current account balances of all four countries.

In September - October 1956, Egypt, Israel and France approached the IMF with financing requests, to overcome temporary balance of payments problems arising from the current account. In 1956, Britain had a significant current account surplus. The pound sterling came under heavy speculative pressure and United Kingdom witnessed short-term capital outflows. The Bank of England was forced to deplete its US dollar reserves to defend the fixed value of the pound sterling against the dollar. By December 1956, the risk of currency devaluation or a floating exchange rate was real. The United Kingdom did not qualify for financial assistance from the IMF. The IMF’s Articles of Agreement prohibit its lending finance to “large and un-sustained” outflow of capital, which Britain faced. The Bank of England had enough resources to credit and fend off the outflow without IMF assistance. That said, the IMF financed all 4 countries with on a stand-by basis. This involvement gave IMF the role of an International Crisis Manager. The Suez Crisis was the first major financial crisis of the post war era.

Egypt was borrowing from the IMF for the second time. It was a conventional financing request for US \$ 15 million and politics did not intrude in the IMF financing of Egypt. The United States spoke in favor, France consented by noting the absence of any legal basis for objecting, Britain and The Netherlands abstained. The IMF decision stated that the IMF expresses no objection to the financing request. Israel had joined the IMF in 1954 and the economy was not stable enough to sustain a fixed exchange rate for its currency. After resisting for several months, the IMF agreed to set a par rate of 1.8 Israeli pounds to the dollar. It was felt that Israel drawing from the IMF could help supplement its foreign exchange reserves and setting a par value for the Israeli currency was a step in this direction. Israel had a quota of US \$ 7.5 million from the IMF in 1957 and the developments in the Mediterranean with consequent rise in military spending contributed to a worsening of the balance of payments

situation. With the lone abstention from Egypt, the IMF financing for Israel was approved on May 15, 1957 at 50 percent of its quota.

By September 1956, France witnessed a situation of low and depleting foreign exchange reserves. The French Franc was subjected to a flight of capital. France sought a financing arrangement for 50 percent of its quota of US \$ 263.5 million. France was also fighting a war in Algeria and had a sharply reduced agricultural output that year due to frosts. These adverse influences disrupted France's balance of payments position significantly. France's current account position deteriorated by US\$ 1.1 billion in 1956 from US \$ 409 million surplus to US \$ 700 million deficit. In October 1956, the IMF approved France's financing request.

Britain had a significant current account surplus and the second largest quota in the IMF after United States. The Bank of England had a parity of US \$ 2.80 to the US Dollar and given the speculation, there was pressure to abandon the sterling parity. Britain viewed the US \$ 2.80 as appropriate for trade purposes, regarded exchange rate stability as essential for preserving the sterling area as a preferential trade zone and as a reserve currency. Britain wanted to keep a minimum balance of US \$ 2 billion reserves, and to fall through that floor would be interpreted as a signal that devaluation or even float was to be seriously considered. As market sentiments had shifted against the Pound Sterling, British authorities knew that they could not hold the pound at US \$ 2.80 per dollar without support of the United States. The IMF financing was to address the psychological impact of a political crisis on financial markets. The Israeli invasion of the Sinai, greatly accelerated the drain on the reserves and the financial pressures drove Britain to accept a ceasefire and full withdrawal in the Mediterranean. The Suez Crisis was suddenly over. Following the ceasefire, American resistance to a British financing arrangement was out of the way and British request for a financing arrangement upto 75 percent of its quota was considered. Britain required US \$ 1.3 billion to stem speculation against the pound. It was felt that given the United Kingdom's role as a banker for a large trading area and the status of sterling as an international currency, the IMF agreed to lend in a situation of a large and sustained capital flows.

The Suez Crisis was the first time the IMF played a significant role in helping countries cope with international crisis. The IMF adopted a rapid response to the crisis and placed a large enough number to impress the financial markets, and convince speculators. Britain had faced a speculative attack on a stable currency against a backdrop of sound economic policies. There was a clash between maintaining a stable exchange rate and establishing open markets for the currency. Britain was unable to restore the level of foreign exchange reserves till 1958.

THE INTERNATIONAL DEBT CRISIS 1982 - 1989

The international debt crisis began on August 20, 1982 when the Mexican Finance Minister informed the bankers assembled in New York that Mexico could not repay the loan that was due and engulfed 20 countries. The Mexican authorities had informed the IMF that without an immediate rescue, Mexico had no option but to default. This was the commencement of a decade long international debt crisis. In March 1981, Poland informed its bank creditors that it could not repay its debt

obligations. A number of Europe's largest commercial banks were heavily exposed with loans to Poland, and European governments had little choice but to rescue these banks. Poland pushed several other countries into the precipice – Romania, Hungary and Yugoslavia also requested for rescheduling the terms of repayment. The monetary contraction in the United States in the 1970-80 period resulted in a sustained appreciation of the US dollar. It made repayments in dollar terms impossibly difficult for most countries of Eastern Europe and Latin America. The commercial debt crisis erupted in 1982 and lasted till 1989.

In the 1970s, developing countries borrowed freely in the rapidly growing international credit markets at low interest rates. Banks had grown cash rich with large deposits from oil-exporting countries and there was increased lending to oil-importing countries. The loans were used on investment projects or to boost current consumption. Several developing countries had reached borrowings 12 percent of their national income, resulting in major debt-servicing difficulties. The monetary contraction in the United States in 1979-80 and the second oil shock resulted in sustained appreciation of the dollar. The May 1980 World Economic Outlook (WEO) said that the outlook for oil-importing developing countries was “frightening” and that current account deficits for those countries were not financeable under the existing development assistance. There was concern in the WEO bordering on urgency, gravity and insistence about the potential problems in most heavily indebted countries.

The overwhelming view was that debt accumulation was beneficial and even a key element in solution to problems of 1970s. No one saw the crisis coming, or who might be affected. Commercial banks believed that sovereign lending to developing countries was a highly profitable activity. Mexico and Poland were the first manifestations of the impending crisis. Soon after Mexico, several countries in Latin America – Argentina, Brazil, Chile, Ecuador, Peru and Uruguay encountered debt-servicing problems. This accelerated the eruption of crisis in other continents also. Clearly too many Governments were pursuing unsustainable economic policies in the contracting economic policy environment of the 1980s. Sub-Saharan African countries with official debts too faced economic catastrophe. The tremors were felt in Asia too with India, Pakistan and China drawing on Fund's support for ambitious development and reform plans. Korea was able to service its debt without restructuring by an effective adjustment and reform program.

The International Debt Crisis lasted from 1981 to 1989. It covered nearly 20 countries around the world encompassing 30 different episodes. The 3 major East European countries affected were Poland, Romania and Hungary and the 3 major Latin American countries affected were Argentina, Brazil and Chile. Each one faced serious debt problems but each one had unique problems in origin and implications. Long-term growth in most heavily indebted countries required innovation and broader strategy. The Baker Plan was formulated to strengthen growth prospects of indebted countries and was followed by the Brady Plan.

Inability to service debt was only a symptom of deeper economic mismanagement in most developing countries. Feasible economic reform programs were put in place by a series of IMF programs under the Stand-By Agreements, Extended Fund Facility and Brady Plan. The strategy drawn up the IMF and the creditor countries envisaged

financing a small portion of the debt through official programs. Traditional IMF relations with Commercial Banks were characterized by arms-length mutual dependency, with Banks financing strong economic policy programs recommended by the Fund. Post-Debt Crisis there was a major change in relations between the IMF and the Commercial Banks. Representing the change, officials of the IMF participated in meetings between the Commercial Banks and Country authorities. Large Stand-By Arrangements and Extended Financing Facilities were put in place to persuade Commercial Banks against rapid withdrawal.

The International Debt Crisis of 1982-89 was addressed through a 3 pronged strategy – it was viewed as a threat to both creditors and debtors, the crisis could only be solved by cooperation between debtors and creditors and resolving the problem required coordinated and centralized action. The Commercial Banks had a collective interest, the Creditor Countries had a collective interest and the coordination efforts were led by an International Agency – the International Monetary Fund. The systemic crisis gradually subsided by 1983, although debt-servicing difficulties remained. The period 1985-87 was a period of sustained growth and developing countries could reduce the burden of servicing debt. By 1989, there was a marked improvement in external economic environment facing many of the indebted countries which brought an end to the international debt crisis.

THE EAST ASIAN CRISIS

A major economic crisis struck many East Asian economies in 1997. The East Asian economies, which were witnessing rapid growth and improvement in living standards, got embroiled in a severe financial crisis. Interrupting a decade of unparalleled economic growth, prosperity and promise, the crisis revealed the precariousness of the systems of economic governance in the region. No one had foreseen that these countries which were widely envisaged as economic models for many other countries could suddenly become embroiled in one of the worst financial crisis of the postwar period. The crisis was a result of large external deficits, inflated property and stock market values, poor prudential regulation, lack of supervision and exchange rate pegs to the US dollar resulting in wide swings to the exchange rates making international competitiveness unsustainable.

The Southeast Asian currency collapse began in Thailand. Thailand's current account deficit and the interest on foreign obligations had exceeded 4 percent of Thailand's GDP. Creditors believed that Thailand's large current account deficit reflected high business investment, as it was backed by high savings rates and government budget surplus. Thailand maintained a fixed exchange rate relative to the dollar. Foreign funds kept coming to Thailand given the high interest rates on Thai baht deposits and the fixed exchange rate at 25 baht per dollar. But the Baht's fixed value to the dollar could not be sustained. In 1996 and 1997 the Japanese Yen declined by 35 percent to the dollar. Wide swings in the dollar/ yen exchange rate contributed to the build-up in the crisis through shifts in the international competitiveness which proved unsustainable. As foreign investors began selling bahts, Government intervened to

support its value. However, the currency could not be sustained and eventually the Thai currency collapsed.

Contagion beset Indonesia and Korea as financial investors became worried about large current account deficits. On July 2, 1997, the Thai baht was floated and depreciated by 15-20 percent. On July 24, 2017 East Asia witnessed a “Currency Meltdown” with severe pressure on the Indonesian rupiah, the Thai baht and the Malaysian ringitt. The 1997 Indonesian economic crisis brought an end to 30 years of uninterrupted economic growth, and was amongst the worst faced by any country in the world in the 20th century. The economic crisis was exacerbated by a political transition which played out with widespread riots and resulted in the election of a new President. The Indonesian rupiah depreciated from about 2500 rupiah per US dollar in May 1997 to around 14000 rupiah per US dollar by January 1998 with imminent hyperinflation and financial meltdown. The closure of 16 banks created panic. The Indonesian authorities responded with steps to provide blanket guarantee for all depositors and creditors, creation of an Indonesian Bank Restructuring Agency and assurances to carry forward corporate restructuring.

In 1997, Korea was the 11th largest economy in the world, with inflation rate less than 5 percent, unemployment rate less than 3 percent and GDP growth was 8 percent per annum. The Korean economic crisis emerged because its business and financial institutions had incurred short term foreign debts of nearly US\$ 110 billion which were 3 times of its foreign exchange reserves. Massive financial bailouts were necessitated, as countries suspended debt payments to private creditors. The Korean won came under severe pressure and Korea opted for an IMF bail-out. Korea required a US\$ 57 billion IMF program, Indonesia required a US\$ 40 billion IMF program.

The social costs of the IMF programs in Indonesia, Thailand and Korea were severe. Sharp price rises were witnessed in all 3 countries as a result of large exchange rate depreciations and massive job losses were seen. Food prices went up by 35 percent. Unemployment levels reached 12 percent in Indonesia, 9 percent in Korea and 8 percent in Thailand. Of the 3 crisis countries, only Korea had formal unemployment insurance, the other countries did not offer social protection arrangements.

The IMF programs in East Asian countries addressed the challenges of prolonged maintenance of pegged exchange rates, lack of enforcement of prudential rules and inadequate supervision of the financial systems, lack of transparency due lack of availability of data, and problems of governance. Capital account liberalization became one of the core purposes of the IMF. There was a significant change in the thinking about the sustainability of fixed exchange rates. It was felt that monetary policy must be firm enough to resist excessive currency depreciation. The IMF programs promoted restructuring and recapitalization of financial institutions. Governance models for public and private sector were improved with transparency

and accountability being strengthened. The IMF programs focused on fiscal policies which reduced the countries' reliance on external savings and taking into account the cost of restructuring and recapitalizing banking systems.

THE RUSSIAN ECONOMIC CRISIS

In the mid 1990s, Russia was coming out of post-Soviet period to a market economy. There was massive social dislocation, fall in living standards, inflation in excess of 300 percent. Many Russians did not have savings for basic necessities of life. Barter was prevalent in several parts of the economy and the concept of debt repayment or legal enforcement was yet to be established. The source of inflation lay in a lack of fiscal discipline – Government ran huge budget deficits financed by the Central Bank of Russia. There was large scale tax evasion and huge capital flight. Fiscal discipline in the run-up to the 1996 election was not forthcoming and the Government did not show any resolve to tackle the budget deficits. The Government lacked the enforcement power to collect taxes from the major industrial and energy sector taxpayers.

Feeble attempts to cut the budget deficits were made in 1995. The Government sought to control the money growth by keeping the exchange rate of the ruble vis-a-vis the US dollar within a preannounced band. Thus money growth was controlled to maintaining the exchange rate. Russia had effectively surrendered large parts of monetary independence in deciding to use the exchange rate as nominal anchor for monetary policy. The tightening of monetary policy supported by the exchange rate anchor produced an impressive reduction of inflation in the short term and an improvement in the confidence of the ruble. Inflation was lowered to less than 50 percent by 1996 and to under 15 percent by the onset of the Asian crisis. Russia accessed international capital markets and foreigners acquired government issued paper. The strong external current account, rising international reserves and an appreciation in exchange rate, covered up the challenges of high debt servicing costs, short term structure of maturities and impact that a sudden depreciation of exchange rate could have on the Nation.

The weakening of the oil prices coupled with the onset of the East Asian crisis in 1997, resulted in a sharp and sudden deterioration in Russia's terms of trade. There was a 25 percent fall in the total exports and there were lower inflows from international capital markets with rising cost of access to international capital. Between 1997-98, faced with a deteriorating balance of payments situation, Russia faced international debt repayments of US \$ 20 billion. The Central Bank of Russia intervened in the market, selling foreign exchange reserves to defend the exchange rate. Market sentiment had deteriorated rapidly and despite borrowings from International Financial Institutions, there was a rapid decline in the reserves position. It was clear that Russia could have avoided the massive disruption it faced if the Government had maintained fiscal discipline. There was a lack of coherence between institutions as the Duma rejected the key elements of the fiscal program recommended by the IMF. There was no credible macroeconomic policy response in the first 6 months of the Russian crisis. By February 1999, the Ruble had lost 70 percent of its value against the dollar and inflation had reached 90 percent. There was

no banking crisis as banks largely served as the payments system and impact of the crisis on balance sheets of enterprises was modest.

Russia declared across the board suspension of debt-service payments including ruble denominated debt and suspension of private sector external payments. The authorities adopted a free floating exchange rate by abandoning the exchange rate anchor and preserved the remaining foreign exchange reserves. The policy focused on keeping the payments system operational. The political impasse between the President and the Duma made budgetary revisions impossible in 1998. Government adopted strict cash management and cut non-essential expenditures. By 1999, a credible economic stabilization program was put in place, with a prudent budget which was passed by the Duma.

The specter of seemingly unmanageable external debt and threat of an uncontrollable hyper-inflation instilled a sense of fiscal discipline into the 1999 Russian Budget. There was an improvement in the oil prices by the third quarter of 1999 enabling Russia to build reserves quickly. Russia recovered quicker than other crisis hit countries in the same period largely due to increase in oil and gas prices. The positive effects of the high oil prices on the Russian economy coupled with fiscally prudent budgets continued up to 2003. These policy corrections enabled Russia to cover the burden of debt service repayments. Fiscal restraint in the face of burgeoning oil revenues enabled the government to rebuild international reserves while slowing the appreciation of the ruble. As the confidence in the ruble and the banking system increased, gradual reduction in inflation was also achieved. Russia adopted wide ranging structural reforms in taxation and legal enforcement. The Soviet era labor and land codes were dismantled. The number of licensed activities were brought down, pension reforms, bankruptcy laws, agricultural land laws were passed. Russia recovered quicker than what any of the observers had predicted.

LATIN AMERICAN DEBT CRISIS - MEXICO, BRAZIL AND ARGENTINA

Latin American debt crisis occurred a number of times, infact 8 major continental crisis occurred in its 200-year history. The first Latin American debt crisis taking place in 1826-1828, followed by crisis in 1873, 1890 and 1931. In the 20th century, Latin America witnessed a major crisis in 1982 – Mexico's default, 1994/ 95 – the Tequila crisis, in 2001/02 Argentina's default, 1999/03 – Brazil's crisis and 2008/09 Global Financial Crisis. Latin America's crisis filled history is invaluable for studying financial crisis.

In February 1995, Mexico approached the IMF for a US \$ 17.8 billion stand-by arrangement for an 18-month program. This was the largest ever financing package approved by the IMF for any member country. The exceptional action was necessary to provide an adequate international response to Mexico's financial crisis and giving confidence to the international financial system. Mexico had achieved a remarkable economic transformation in 1980s on the basis of far reaching structural reforms. The Government's program had resulted in a sharp reduction in fiscal imbalances, a reduction in the role of the State in the economy, a lowering of inflation to close to international levels. During 1994, investors' concerns about the sustainability of the current account deficit began to increase, against the background of dramatic adverse

political events in Mexico. To stem capital outflows, the authorities raised interest rates and depreciated the peso. Nevertheless, there was a significant loss of external reserves and there was tremendous pressure on foreign exchange and financial markets precipitated a financial crisis. The Mexican financial crisis contributed to serious pressures in financial and exchange markets in a number of other Latin American countries.

In 1998, Brazil came under significant pressure in the aftermath of the East Asian crisis, as contagion resulted in a dramatic worsening of the international financial environment. Brazilian authorities took emergency fiscal and monetary policy measures – revenue raising and expenditure cuts equivalent to 2 ½ percent of GDP and doubling the domestic lending rates to 43 ½ percent. By August 1998, the capital account came under serious pressure in the aftermath of the Russian crisis, necessitating additional expenditure cuts and fiscal tightening measures. Despite these measures, foreign exchange reserves declined from US \$ 70 billion to US \$ 45 billion in 3 months from July to October 1998, and Brazil was in need of a major economic restructuring program. Brazil approached the IMF for an US \$ 18 billion stand-by arrangement for 36 months. The program was largely preventive in nature with the objective to assist Brazil face a period of deep uncertainty in the international financial markets.

In 2001-02 Argentina experienced one of the worst economic crisis in its history. GDP fell by 20 percent over 3 years, inflation reignited, Argentina defaulted on its sovereign debt, the banking system was paralyzed and the Argentine Peso which was pegged to the US Dollar reached lows of Arg \$ 3.90 to US dollar in June 2002. Less than a year earlier Argentina was cited as a model of successful economic reform, inflation was in single digits, GDP growth was impressive, and the economy had successfully weathered the storm of the Tequila crisis. Argentina was considered a model reformer of the 21st century economic governance. The 2002 Argentina crisis was not driven by large money financed deficits and hyper-inflation but by fragility in the public sector debt dynamics. The currency board arrangement precluded direct money financing of budget deficits. In the run-up to the crisis there was price deflation and banking system appeared sound and well capitalized.

The currency board arrangement played a central role between Argentina's transformation from a star performer to a crisis country. Initially the currency board played a role in achieving disinflation, once Argentina slid into recession, the currency board arrangement limited Argentina's ability to prevent a tightening of monetary policy and the public debt dynamics ruled out loosening of fiscal policy. The entire onus of macroeconomic stabilization was on fiscal policy, and Argentina seemed trapped in a monetary policy regime that constrained policy choices. Rising fiscal deficits, government's high off budget activities and extensive transfers of over 30 percent to provinces from Federal budgets and interest repayments severely constrained Argentina's policy options. The share of exports in Argentina's economy was limited and the country could not export its way out of the crisis. Debt service payments were absorbing 3/4th of the exports earnings. Amidst dramatically mounting debt, given the currency's free fall, Argentina defaulted on government debt and the currency board collapsed.

Argentina crisis required an IMF Stand-By Arrangement of US \$ 14 billion and an international support package of US \$ 40 billion. The macroeconomic stabilization program sought to bring public sector surplus to 1 ½ percent of GDP from ½ percent of GDP and reduce fiscal deficit from (-) 6.4 percent to 3 percent of GDP. Despite these interventions, GDP growth continued to decline, falling by 11 percent in 2002 and unemployment rose above 20 percent with significant inflation. Argentina passed a zero deficit law, and made radical policy changes as it ran out of funding options.

THE GREAT RECESSION

In 2008 severe recession unfolded in the United States and Europe which was the deepest slump in the world economy since 1930 and first annual contraction since the postwar period. The financial crisis which erupted in 2007 with the US sub-prime crisis deepened and entered a tumultuous phase by 2008. The impact was felt across the global financial system including in emerging markets. The 2008 deterioration of global economic performance followed years of sustained expansion built on the increasing integration of emerging and developing economies into the global economy. Lax regulatory and macroeconomic policies contributed to a buildup in imbalances across financial, housing and commodity markets. The international financial system was devastated.

The United States GDP fell by nearly 4 percent in the 4th quarter of 2008 with the broadest of US market indices, the S&P500 down by 45 percent from its 2007 high. World GDP growth slowed down from 5 percent in 2007 to 3 ¾ percent in 2008 and 2 percent in 2009. The IMF estimated the loan losses for global financial institutions at US \$ 1.5 trillion. The Lehman Brothers collapsed in September 2008. The credit freeze brought the global financial system to the brink of a collapse. Weakening global demand depressed commodity prices. Oil prices declined by over 50 percent as also food and other commodity prices. Emerging equity markets lost about a third of their value in local currency terms and more than 40 percent of their value in US dollar terms. Comprehensive policy actions were implemented to address the root causes of the financial crisis and to support demand. Faced with an imminent meltdown, the US Federal Reserve and the European Central Bank injected US \$ 2.5 trillion into the credit markets. The United States passed an economic stimulus legislation to use public funds to purchase troubled assets from banks and several European countries implemented stimulus packages to manage the financial damage.

Policymakers around the world faced the daunting challenge of stabilizing financial conditions while simultaneously nursing their economies through a period of slower growth and containing inflation. Multilateral efforts were particularly important. During this period, China's geopolitical standing enhanced significantly. As the G8 member countries grappled with the crisis, it was important that given its mandate and wealth China had to be included in the discussions. The G20 framework representing 19 of the world's largest economies and the European Union became the coordinating body for handling the global crisis. The policy actions included programs to purchase distressed assets, use of public funds to recapitalize banks and provide comprehensive guarantees, and a coordinated reduction in policy rates by major central banks. Advanced economies as also emerging market economies witnessed moderation of inflation pressures due to rapidly slowing economic activity. There was scope for monetary easing and discretionary fiscal stimulus to support growth without

undermining fiscal sustainability. Multilateral efforts were initiated to plug gaps in regulatory and supervisory infrastructure, fostering energy conservation and greater oil and food supplies, and enhanced efforts for unwinding the global imbalances. The effective appreciation of the renminbi and shifting resources of China and Middle East Oil Exporters to internal demand were pursued.

By October 2009, economic growth turned positive as wide ranging policy intervention supported demand and lowered the uncertainty of systemic risks to the financial system. Although the pace of recovery was slow, there was a rebound in commodity prices, pickup in manufacturing and a return of consumer confidence with firmer confidence in housing markets. The triggers for the rebound were strong public policies across the advanced economies and emerging market economies which supported demand and eliminated fears of a global depression. Central Banks reacted with exceptionally large rate cuts and Governments launched major fiscal stimulus programs. As the world economy ended 2009, the key policy challenge was to maintain supportive macroeconomic policies till the recovery was on firm footing. The withdrawal of the fiscal stimulus posed a risk in the near term, and the challenge was to map the timing of tightening of accommodative monetary policy conditions. The other policy challenge was to heal the financial sector while reforming the prudential framework. There were structural and social challenges of rising unemployment and poverty. Each of these challenges required international policy collaboration and cooperation which was achieved through the G20.

By April 2010, the world GDP growth was projected to rise to 4 ¼ percent based on highly accommodative monetary policies and supportive fiscal policies. The recovery had proceeded better than expected, and the world economy had reached a stage where monetary accommodation could be unwound cautiously with nominal exchange rate appreciation. Reform and repair of the financial sector remained a top priority for a number of advanced economies. This was taken up in the subsequent years.

EUROPEAN CRISIS

The year 2010, the European crisis unfolded. The euro area economy was in a terrible mess. The euro currency area had become too large and diverse – with the anti-inflation mandate of the European Central Bank too restrictive. There were no fiscal mechanisms to transfer resources across regions. A group of European Emerging Market Countries required financial support in 2008-09. The group included Georgia, Hungary, Iceland, Latvia, Ukraine, Armenia, Bosnia and Herzegovina, Romania and Serbia. The euro area crisis countries of Greece (2011, 2012), Ireland (2010), Portugal (2011) and Cyprus (2013) faced problems of problems of public and private balance sheet vulnerabilities with large current account imbalances within the Euro Area.

In Greece, the homeless lined up at soup kitchens, pensioners committed suicide, the sick could not get prescription medicines, shops were shuttered and scavengers picked through dustbins – conditions almost reminiscent of the post war Europe. Every person under 25 was unemployed. Greece economy was teetering due to heavy public debt and loss of market access. High fiscal deficits and dependency on foreign

borrowing fuelled demand. Entry to Euro Area had enabled Greece to access low cost credit, boost domestic demand with an average growth rate of 4 percent. Greece also ran pro-cyclical fiscal policies with tax cuts, increasing spending on wages and ran fiscal deficits of 7 percent for the period 2000-2008. Health care and pension costs were very high at 4.5 percent and 12.5 percent of GDP respectively. Further, Greece had a poor business environment, high inflation well above the Eurozone average and low productivity. The governance systems were poor, hardly any inward FDI and public sector was highly inefficient.

The Greece authorities made feeble attempts initially to address vulnerabilities like reducing the fiscal deficit. The efforts were not convincing and concerns about fiscal sustainability deepened with a further weakening of the market sentiment. Foreign funding dried up and there was a loss of confidence in the banking system. There were sovereign downgrades by rating agencies, sharp increases in non-performing loans, and decline in viability of banks. Greece was misreporting its fiscal data for access to foreign borrowing. The fiscal deficit for 2008 was revised from 5 percent of GDP to 7.7 percent of GDP and the fiscal deficit for 2009 was revised from 3.7 percent of GDP to 13.6 percent of GDP. The 2009 public debt data was revised from 99.6 percent of GDP to 115.1 percent of GDP. Greece needed a strong and sustained adjustment program to lower fiscal deficits, to decline its debt ratio and improve its competitiveness. The IMF stand-by arrangement in 2010 for Greece was Euro 28 billion and bilateral program assistance was provided by Greece's 15 partner Eurozone countries, in ratio of their shares in the European Central Bank capital. Greece required an additional program with the IMF in 2012 amounting Euro 30 billion. The Greece program aimed at restoring confidence and fiscal sustainability to regain market access, restore competitiveness and safeguard financial sector stability.

The unprecedented crisis in the Euro Area also affected Ireland and Portugal. In Ireland the global crisis had major repercussions on the Irish Banking sector. This was coupled with the bursting of the real market bubble resulting in a 41 percent collapse of investment and a severe economic downturn, resulting in rising bank losses and growing difficulties for banks to secure wholesale financing. The lack of market funding access and large outflows of wholesale deposits by corporates, banks increasingly relied on Central Bank funding to replace maturing liabilities. Ireland's exposure was Euro 90 billion through European Central Bank and at Euro 150 billion through the Central Bank of Ireland. The initial crisis response from the Irish authorities was insufficient to stabilize the economy and Ireland required an IMF program of Euro 22.5 billion.

Against the backdrop of crisis in Greece and Ireland and fear of euro area contagion, Portugal also faced a sudden drop in financing in 2011. Portugal had the lowest per capita income of founding member countries when it joined the euro area. Easy financing with euro accession sparked a spending boom and build-up of debt.

Portugal failed to adhere to the fiscal rules of EU's stability and growth pact. By 2010, when financing began to dry up, Portugal had twin deficits – current account and fiscal, of 10 percent of GDP, and public and private debt, which were amongst the highest in the euro area. Portugal required an IMF financing program of Euro 26 billion.

The crisis in the Euro Area was unprecedented, coming against the backdrop of global financial crisis, the risks of contagion were very high. The key challenges included abrupt loss of market access, need for orderly adjustments in countries with deep imbalances and no recourse to exchange rate policies, and absence of euro area firewalls. The stabilization programs were successful in giving time to build firewalls, preventing the crisis from spreading and restoring growth and market access. That the Euro Area remains together represents a collective success story for the IMF, the International Partners and the Program Countries.

CONCLUSION

I have tried to give a broad overview of the key events that shaped the international monetary system over the past century. Pre-World War I, the highly credible gold standard provided long term exchange rate stability and eliminated exchange rate risk. The October 1929, the Great Depression meant a sudden stop of foreign capital flows to United States and Europe. As the pound was devalued, massive capital flight occurred resulting in competitive devaluations, exchange restrictions, capital controls and trade barriers. The 1944 Bretton Woods Conference resulted in the creation of the International Monetary Fund and formulation of a set of rules to address the challenges. By 1972, the Bretton Woods Agreement had collapsed and the IMF's Articles of Agreement were amended to legitimize floating exchange rates. The first 20 years of floating exchange rates were disappointing with the emergence of imbalances between the advanced economies and the developing countries. Capital account crises were witnessed in several emerging market countries in 1990s to 2000s like Mexico in 1994, Asian Economies in 1996/97, Russia in 1998, Brazil in 1999, and Argentina in 2002. The IMF was in doldrums in the early 2000s, with no lending, except for concessional lending to Low Income Countries. The United States kept running large deficits while China, Japan and Germany ran large current account surpluses. The Great Recession occurred in 2008. During the Great Recession, as in the Great Depression, the world economy witnessed volatile capital flows, scramble for reserves, an asymmetric burden of adjustment, secular stagnation and concerns about currency wars.

There are parallels between the Great Depression and the Great Recession. There are challenges arising from unemployment, economic frustration and social tension: all of which are a legacy of the financial crisis. The currency wars of today resemble the currency depreciations, exchange rate restrictions and trade barriers of the 1930s. The

current issues witnessed in the international monetary system - the scramble for international reserves, the risk of secular stagnation and the world of secular stagnation becoming a world of currency wars were witnessed in the past too. With monetary policy at its limits, fiscal policy hobbled by high debt and political constraints, it becomes very tempting to boost aggregate demand through currency depreciation. The issues of international policy coordination requires increased multilateralism.

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