PRUDENTIAL PROVISIONING, RELEVANT RELOCATION

Exchange Control Revisited

INTRODUCTORY SUMMARY

The present economic crises particularly in Asia but also Russia and, by contagion, Latin America with partial transmission to and potential contagion in Western Europe/North America are in large part caused by excessive short term financial capital movements. That they interact with relatively (to very) weak financial system, asset price bubbles over-investment, misallocated investment and (except in the late Japanese case) overvalued exchange rates is not in question. But each of these structural weaknesses has in large measure been caused by massive short term capital inflow and exacerbated by massive outflows and consequential real economy contraction devalidating investment decisions, asset prices and lending serviceability which were certainly not reckless at micro level and probably not at macro level when made.

These results - which in some aspects repeat on a larger scale the 1980's Southern Cone and 1995 Tequila crises - strongly suggest unlimited, unregulated and to large extent unknown until *ex post* short term capital account flows are both economically, socially and politically destabilising and damaging. This is neither a general argument against international exchange liberalisation - trade flow results can at times be damaging but not in the same ways or to the same extent and nobody seriously proposes totally liberalised migration of labour. Capital flows - or at least short term capital flows - are arguable distinctly different, a case mode by perfectly orthodox free traders like Jagdish Bhagwati.

Nor is this argument based on the contention either that all or all short term international capital flows are damaging. It is simply that unlimited, unreserved, unregulated, at the time unknown short term flows can be damaging. In the analogous case of domestic deposit taking financial institutions is conventional wisdom. There are several reasons no parallel conventional wisdom has evolved in respect of territorial (national or currency area) external liability provisioning, prudential regulation and reporting:

1. the mid 1990's flow levels (absolutely, relative to trade and relative to total investment are **totally disproportionate to those of the 1980's - let alone any previous** decade - and in country coverage are also much wider than the early 1990's;

2. the **diffusion** of lenders and **borrowers is much greater**. Up to the late 1980's - beyond the OECD group the bulk of external debt at risk (and of the burden on economies at risk from external debt) was sovereign or para sovereign (state guaranteed state enterprise) or private bank debt 'nationalised' when at risk of default. Whatever else this structure did, it simplified monitoring and negotiating. The last category - 'nationalised' when at risk - was basically the external debt of domestic financial institutions (especially banks) deemed too large or too crucial to allow to fail. Arguably these were dominant in the 'tequila crisis' and played a large role in other instances e.g. the earlier Southern Cone implosion (especially in the Chicago Cowboys' Chile) and later in the late and post Marcos Philippine debt overhang. By the mid 1990's substantial proportions of short term (as well as longer term) external debt was, in some Southern economies **directly raised by non-bank domestic enterprises**. Such debt had not posed significant problems before because few if any South enterprises could raise substantial sums externally except through a domestic bank or with the guarantee of a major Northern enterprise (usually a parent).

3. **Exchange controls** on capital account had largely been oriented to **limiting outflows** (including overseas investment as much as repatriation of external borrowing of foreign investment) with very little attention to managing inflows (rarely a perceived problem). They had gradually eroded in the North with final dismantling (albeit from rather limited coverage) in the 1980's as the end of a 30 year process, Southern liberalisation had - with a handful of exceptions - been much more recent (largely 1990's), therefore the more rapid than in the North and apparently more on uniform acceptance of the "Washington Consensus" than of any contextual analysis of what to remove, how fast, in what order and with which (if any) retentions, substitutions or safeguards. This may in part have been because 1930's-1980's exchange controls had taken the form of across the board prohibitions with limited politically or administratively alterable classes of exceptions and non-transparent politically or bureaucratically determined exceptions with very little attempt to make use of, relate to, or to regulate rather than to block, market forces. This is not the only possible form of exchange controls, but it was the ubiquitous face of

existing ones-partly because most were adopted under pressure to control actual or imminent massive outflows. This anti market image was compounded by the interaction of capital account exchange invisible import/foreign travel and currency controls.

Two aspects of the present crises appear to have been subject to inadequate or unbalanced analysis:

1. there has been a dominant perception - by no means a universal one vide Chile - that the basic problem is keeping short term financial capital in a country once it has arrived (i.e. limiting outflows) with inadequate attention to analysis of the harm - as well as future vulnerability to volatility - caused by very large inflows. This is in medical terms concentration on cure with limited attention to preventative (inflow reserving/prudential regulation) or environmental (general financial institutional structure) aspects. "Prevention is better than cure" has not been an axium much honoured in the 1930/1980's exchange control or 1990's post exchange control eras;

2. linked to severe over-emphasis on 'speculative' capital, in particular hedge funds and their perceived personification Mr. George Soros. Most short term footloose financial capital movements are not 'speculative' nor are those making them following Monte Carlo strategies. Interest rate/exchange fluctuation arbitrage, risk limitation (the rationale of short term loans even when the underlying investment/cause of borrowing is medium to long term and collective non rollover will clearly - *ex ante* as well as *ex post* - precipitate a crisis) and avoiding doing worse than comparators are their hallmarks. These appear to be combined with a certain naivete on the inswing and a lemming pattern (running in a pack for 'safety' even when that ensures falling into a chasm) on the outrush. Hedge funds (including proprietary sections of investment banks) do take positions which are known to have substantial risk and to offer substantial payoffs - but are much smaller and later operators. Their role can be overstated - as in Hong Kong they can create rigged markets but usually they pounce when they believe stock or currency prices are unsustainably out of line with fundamentals. Their pronouncements and believed changes in their positions can panic the lemmings, e.g. Soros' declamation on the need for Russian devaluation and a currency board, but usually only once fundamentals are so shaky that there is already a financial avalanche waiting for even a minor shock. Omniscient they are not - the Soros' letter apparently triggered a $1,000 million plus loss for his financial vehicles. The LTCM case suggests that their main threat is to Northern Financial

institutions and certainly raises doubts as to the complex risk calculator and layoff practices of at least some multinational investment banks, let alone of the LTCM model which was simplistic to the point of naïve, was not adjusted despite 1997 result warnings of economic variable movement outside historic parameters and (perhaps most tellingly) in its 1995-1996 high noon delivered by 50 to 100 to 1 leveraging about the same return to equity owners as a Wall Street Index Fund!

In looking at the current and emerging crises and the possible role of preventative, proactive and responsive (in that order of potential payoff) reserving and regulation ("neo-exchange control"?) deserves priority analysis subject to three caveats:

1. **significantly overvalued exchange rates** persisted in for an extended period do build up forces which are almost impossible to manage when devaluation is accepted (or even deliberately initiated);

2. **financial institution (and other enterprise) prudential regulation and reserving** is broader than that for short term external financial liabilities (or for that matter assets) as are financial and other enterprise **transparency** requirements:

3. **overinvestment/misallocated investment/bubble markets** are not caused - so much as facilitated and exaggerated - by short (or for that matter long) term external finance inflows.

In each case the short external flows are likely to be a substantial part both of the problem and of the answer but by no means the whole of it. Japan, for example, demonstrates that asset price bubbles leading to financial system debilitation and prudential (at micro level) consumption/investment reduction can lead to a recession by implosion even if the current account is substantially in surplus and Russia's 1994-1998 road to ruin turned - at macro economic level at least - on a Ponzi type financing of a domestic fiscal deficit and a massive outflow of (prudential?) capital temporarily 'validated' by increasing short term/sky high interest rate short term financial capital inflows. This pattern is quite unlike that of the Asian reverse miracle economies and is also less avertible by prudential inflow reserving/regulation.

Further - as the evident differences among Korea, Russia, Brazil or, indeed, Korea/Indonesia/Philippines - suggest there are both general principles to be analysed and general policy guidelines to be sought and contextual settings to be taken into account. In that respect various sets of terms need both clarification and differentiation:

a. **contagion/transmission**. Presumably contagion means either application of aversion/withdrawal to genuinely similar economies with similar external flow and balance patterns or/and their (mis)application to dissimilar economies. If that is so Thailand to Indonesia to Korea to Malaysia and in a less pronounced form to the Philippines is 'valid' contagion and to Brazil/Argentina arguably 'misplaced' contagion;

b. **transmission** - differentiated from contagion - should mean the impact of initial crisis economies on others. China, for example, is suffering from transmission of 'reverse miracle' economy shocks more than from contagion. That is also the case for Hong Kong and Singapore. European and Northern American recessionary and asset valuation pressures are primarily/overwhelmingly transmission (to date. Stock market meltdowns would in practice have a high misplaced contagion component).

Russia is in practice partly contagion. Its crisis is, however, primarily because its fundamentals were far less sound and its external flows and balances were far less sustainable (and far more evidently unsustainable) than those of - say - Thailand. Indeed the logical question is not why George Soros' pronunicamento on reform catalysed a crisis but why there had not been one 18 months, or at least a year (parallel to the moulting of the tigers) earlier. The only apparent reasons are faith (against evidence and logic) that honest liberalisers could put the fiscal imbalance right and transform primitive accumulation and asset export of a peculiarly rapacious and non-productive (in real macro economic terms) type into a less non creatively destructive form of capitalism and do it fast or that the "Indonesia with nukes" perception guaranteed endless and unlimited G7 bailouts.

Overinvestment, misallocation of investment, non-transparency, cronyism, corruption and tilted playing fields are another set of terms used both loosely and in sloppily overlapping ways. The first does have a real relevance to the property and financial bubbles of Thailand, Malaysia, Korea and (probably) Indonesia as well as to their gross overexpansion of capacity in - notably - chips, other electronics, automobiles and steel. It probably has less cutting edge vis a vis Brazil, Argentina, Philippines or Singapore and next

to none for Russia. **Misallocation** is a fact but the term seems to be being used either to attack government policies intended to pick winners or to imply favouritism/corruption. As to the former, the irony is that gross overinvestment and picking losers seems to have risen rapidly in Korea precisely as targeting winners was liberalised (if that is the word) to the chaebol in the 1990's! The 'new' 1997/8 state policy of encouraging chaebol to concentrate on a few core lines and to exchange peripheral holdings with other chaebol is arguably a reversion to the historic line of picking two to four "national champions" for which to provide an enabling climate in order to achieve economies of scale and focused attention/expertise consistent with at least some domestic competition. It was the chaebol, not the state, who rushed into each others' back yards and built up incredibly high debt/equity ratios and rates of capacity expansion relative to plausible projections of domestic plus foreign demand. In the latter usage misallocation is a rather opacity building choice of term.

Non transparency again has two aspects - lack of regularly collected, standardised and timeously published data and hiding corruption or favouritism. Doubtless the second is helped by the first but it is not helpful to encompass both by one term nor to imply that the only (or even the basic) purpose of transparency is to hinder fraud. "**Cronyism**" has become a new coverall term for nepotism, overlooked (in either or both meanings of that word) fraud, selection of "national champions", "old boy networks" (in practice only 'old girl' in cases of nepotism) and defective regulation e.g. "first come, first served" even when the second cover offered a better bargain. Tilted (presumptively the opposite of level) playing fields is used similarly. Again differentiation is likely to be important. Any non-transparent, relatively discretionary (even with guidelines) policy/praxis model is likely to accrete corruption over time, whether local council contracting in the UK or priority product champion picking in Korea. But policy corroded by corruption has not necessarily the same impact as political contributions to secure preliminary access nor compulsory crony (in a stricter sense) partners unlinked to any broader policy frame. The value of avoiding misplaced coyness about malpractice - calling a spade a spade - is unlikely to be well serving by conflating malpractice, mistakes and mistaken policies - resulting in calling everything from a tea spoon to a grab line excavator a spade.

PROBLEMS OF RISING TIDES

Capital **inflows** have rarely been perceived by orthodox economists as causing serious structural or institutional problems. (External buy up of a territorial economy is a perceived and discussed risk but for structuralists not liberalisers.) This probably turns on two historic facts:

1. short term capital flows were until the 1980's largely closely linked to trade finance or to parent company finance of subsidiary working capital needs;

2. the dominant form of investment was foreign direct investment was foreign direct investment in enterprise equity and medium to long term loans;

3. with a few exceptions, net private capital flows to poor countries before the mid 1970's were relatively small until the 1970's especially so relative to overall major financial enterprise resources;

4. government to government sovereign debt posed (or was perceived as posing) few problems because it was expected to be rolled over/replaced by new until the economy took off and to be used in building up infrastructure. Bank to government sovereign lending was perceived as problematic but only in the context of joint borrower-lender imprudence and - on the basis of 1970's LA debt crisis management - was thought to be manageable, *ex post*.

Some warnings as to the risk of future debt service profiles and the danger of state (or from the late 1970's) or 1980's use of high interest, short term borrowing to avoid more sustainable external or fiscal account imbalance were made. However, these were seen as risks of poor debt management or general fiscal imprudence not of international financial flows per se. Investment beyond levels at which returns justified it was occasionally posed as a macro problem but almost only in respect to bilateral and IFI flows not private sector ones.

In the 1990's rather more basic and readily evident distortions have resulted from massive and dominantly private sector short term (primarily inter bank loans and credits, though secondarily short term government paper and in some cases foreign currency denominated bank accounts, non financial enterprise short borrowing for long investment and portfolio investment). Almost any country or internationally known bank could secure large sums of

30 to 180 day funding so long as its exchange rate appeared stable or subject to low risk of sudden falls (often as a direct result of the inflow!) and the spread over the lenders' home rates was deemed adequate to cover a risk premium. For example, with home deposit and treasury bill rates of 0% to 5% Taiwanese and Japanese sources in the mid 1990's found 8% to 12% rates in the Philippines and a currency *de facto* moving with the USA$ (adding principal appreciation after mid 1995 for Japanese lenders) highly attractive. At the other end of the scale Kenya, Uganda and Tanzania in peak borrowing years sold net treasury obligations of up to 50% of export value but at interest rates often over 50% and sometimes up to 150% tax free (not perhaps the most sustainable route to closing fiscal or trade gaps even though endorsed at the time by the IMF in each case and 'effective' in achieving nominal as well as real appreciation against the USA$ despite domestic inflation rates largely in the 10% to 25% range). The largest extreme case was that of Russia which ran up perhaps $75-100,000 million ruble denominated, externally held treasury paper and interbank credits as an alternative to collecting taxes and a means to facilitating externalisation of assets (not necessarily, albeit in large part, capital flight) by the new privatised economic elite.

In retrospect (and logically in large part in prospect as well) the disadvantages of these levels of flows and of the interest and exchange rate strategy and tactic used to 'achieve' them - especially when short term and largely unrelated to viable investment projects/programmes capable of generating funds and transferring foreign exchange to meet them - are multiple:

1. sustaining or aggravating **overvaluation**. To the extent that the inflow (short or long) plugged external deficits, they tended to stabilise the nominal exchange rate and to the extent inflows exceeded the previous gap plus flow generated (e.g. additional investment and additional employee related) imports they tended to push it up. As most flows recipients had inflation well above USA - Western Europe levels, even stabilising the nominal rate meant increasing overvaluation . The cases in which the nominal rate did not rise tended to be these in which either fiscal deficits or domestic capital externalisation (whether for asset diversification, new investment or precautionary reasons) ate up much of the inflow. Korea - Thailand - Singapore - Malaysia - Philippines did not revalue significantly nominally (as opposed to up to 50% in real terms) both because of substantial recorded and unrecorded investment outflows (over 1994-1997 up to $25,000 million unrecorded for Korea - Thailand - Malaysia - Singapore - Philippines - Indonesia according to the IMF which, however, wrongly treats

unrecorded as synonymous with "flight") and deliberate Central Bank attempts to avert or reverse nominal appreciation by market interventios which substantially increased their external reserves. (They had no strategy of sucking in short term external flows to raise CB reserves; Brazil in 1997-98 did.) Only Indonesia attempted - with considerable success from the late 1980's to mid 1997 - to maintain a stable real exchange rates by nudging the market down by a series of small interventions (usually totalling 6% to 9% a year) to offset domestic excess inflation. This did not deter foreign resource inflows but added a projected devaluation premium, e.g. if the going annual rate for interbank credits or treasury bills denominated in pesos to the Philippines was 12% to 15% it would tend to be 20% to 25% in rupiah for Indonesia.

2. **Raising domestic interest rates**, especially in savings short countries and those funding large fiscal deficits via short term/externally held paper. In extreme cases - e.g. East African ones - one had the curious policy posture of pushing for 25% to 30% nominal prime enterprise lending rates (5% to 10% real) while paying two to five times as much on Treasury paper. In other cases the driving force at times was domestic monetary policy set rates which did suck in footloose, rate/risk arbitraging financial capital (e.g. South Africa, Philippines). In the cases of **high domestic savings/high investment/high capital gross outflow cases** (e.g. Malaysia, Thailand, Singapore, Korea) the domestic interest rate impact is less clear and may on balance have been to **lower** them marginally by market flooding. In these cases - except Singapore - banking institutional patterns meant that competition to loan primarily took the form of increased acceptable debt/equity ratios and less creditworthiness assessment in general, not in lower interest rates.

The impact on medium (3 to 5 year) and long (over five year) loans or securities is less clear partly because in most cases, except for sovereign debt, these are small relative to short are non-transparent and are traded - if at all - in narrow, shallow markets. In principle given the limited domestic long term investment loan base - even in countries with very high domestic savings rates - the external flows (including short to the extent they spilled over to long) should have reduced interest rates. In practice, at least in Asia, they seem to have increased flows at interest rates similar (to the extent known) to annual average short rates i.e. a flat or inverted maturity/interest rate profile. They may have encouraged the beginning of domestic bond markets in the large LA and SEA economies

albeit, especially in the latter, these were as of 1997 limited, fragmented and usually focused on a few finance companies, investment banks and/or project or joint venture co-shareholders.

3. Massive inflows tended to create **bubbles** in two senses - especially in countries with high domestic savings, fiscal position of recurrent account fiscal and balance of payments surplus and moderate (5% to 10%) inflation. Domestically the bubbles were in asset prices - primarily buildings (commercial, upper and middle income residential), land and stocks. These bubble effects were distinctly uneven with Thailand, Malaysia, South Korea and Indonesia the most severely impacted (looking at the current crisis itself, albeit Japan's weak real economy and desperately fragile financial institutions do flow in large part form its 1980's bubble. That was arguably triggered by excess capital availability but domestic savings fed and with very low nominal and real interest rates). The Russian and Latin American cases in the late 1990's - like that of the Philippines - do not appear to be significantly asset price bubble influenced. **Externally a parallel bubble** phenomenon interacted - high interest rates sustaining nominal exchange rates with asset bubble prices making projects, credit and macro economic growth risks as well as exchange rate risks low created a bubble in respect to term bank line of credit, sovereign short term paper and stock market portfolio investment which interacted to blow up the domestic bubbles further.

4. **Investment viability/due diligence investigation and allocation patters** were worsened when inflows resulted in **excess availability of capital** (South Korea, Malaysia, Thailand, Indonesia) or **propping up blatantly unsustainable imbalances** (Russia) though probably less so where they supplemented low (5% to 10%) or moderate (10% to 20%) domestic savings rates. The high supply of lendable resources encouraged banks to lend (foreign to domestic banks and secondarily other enterprises, domestic banks to domestic enterprises) and to compete by lowering quality standards and raising accepted debt/equity ratios rather than on price. With high growth and asset price inflation enterprises were encouraged both to invest in riskier projects (including ones whose viability turned on very high export and/or domestic demand growth including and dependent on but not limited to continued property booms). It also contributed to accepting or seeking very high leveraging even though logically the riskier the project the lower the prudent leveraging. The massive chip, steel and automobile capacity expansion

- by no means only in Korea - are notable examples whose viability depended on increasing shares of global sales with limited price cutting. The stability of nominal exchange rates - and in many cases the belief in easy, massive export expansion - reduced evaluation of (and hedging against) the risks of assuming foreign exchange denominated obligations;

5. **Transparency** - indeed ability to know levels and natures of future foreign exchange liabilities - was eroded. The increase in the number of direct external borrowers, the shortening of the credit profile and the multiplication of types of obligations (including forward forex transactions, and to a lesser degree derivations more generally) had this effect quite independent of any desire to conceal. The 1980's debt crises had improved consolidated sovereign debt data preparation (but not forward selling by central banks which was then relatively minor but in 1997 had eaten up 90% of the Bank of Thailand's 'useable reserves by the time the July crisis exploded) and to a degree major interbank loans and credits. Very little was in fact achieved in respect to short term non bank external borrowing (assumed to be dominantly trade finance and - even though this was demonstrably doubtful - unlikely to change on a large scale rapidly enough to be a key crisis component) or even long term (relatively rare in the 1980's). Further how to handle "off balance sheet"/contingent liabilities e.g. foreign portfolio (as opposed to direct) investment and derivatives (where face value of underlying instruments would be a massive overstatement but - as recent northern hedge fund/investment bank experience demonstrates - historic models of risk tend grievously to underestimate);

6. **Vulnerability** to rapid, massive payments crises increased because of the short debt profile and rising ratios to foreign exchange earnings of debt and of interest and - when short term is dominant (almost all case except probably Argentina) - especially short term repayment obligations in case of non-renewal/non replacement;

7. This **vulnerability** was reinforced by the - apparently virtually unrecognised fact - that a **payments crisis** threatening the stability (or in the case of Indonesia stable downward float trajectory) of the exchange rate was **likely to lead to a precipitate exchange rate fall overshooting** (on the downside) the pre crisis 'equilibrium' rate;

8. And **financial institution vulnerability** was raised both by the reality that in a crisis interbank credits would be reduced or withdrawn (as documented *ex post* by the IMF), the exchange rate would fall (entailing significant losses) and many domestic borrowers would be afflicted by asset bubble bursts, falsified domestic and external demand growth projections and by overall bank attempts to limit/withdrawn credit to improve their balance sheets resulting in rapidly rising 'bad loan' ratios. Because bankruptcy of a banking system is likely to result both in meltdown of the real economy and flare-up to violence of domestic depositors **bank vulnerability virtually forces domestic government supportive action** to a degree and an extent bankruptcy of non-financial and non-deposit taking financial enterprises does not.

9. The **link** if any between **external financial inflows and cronyism/corruption** is **not clear.** Up to some levels of cost and predictability external investors (including bank lenders) usually treat corruption as a cost rather than as an absolute barrier to investment. Similarly cronyism in the sense of requisite domestic partners (or 'partners') is evaluated in terms of probable return ranges including the costs/benefits from the partners. That is true whatever the level of capital inflows (or outflows). Beyond some level perceived growth in level and perceived declines in predictability of cronyism/corruption - or any other costs/ risks - can build up to a reversal of flows - arguably relevant to the Russia case. Also financial inflows do mask - for a time - structural institutional problems so may delay reforms and allow underlying problems to worsen.

The problems cited arise primarily from short term/footloose financial capital flows. The most important reason is that these flows are the largest and the most unstable. Within the short term category, interbank loans and lines of credit plus forward transactions are dominant in most cases. Other components of importance in some cases are domestic currency sovereign debt (treasury bills) and hard currency denominated bank deposits as well as portfolio investment in equities not constituting a strategic stake nor linked to direct foreign investment. Second, within a frame of free capital account transfers, these are the flows which can reverse rapidly and to outflow levels very large in respect to official and financial system external resources. Third, the intra bank (or at least bank routed) flows - including forward transactions and external currency denominated deposits - and the domestic currency denominated, externally owned short term government obligations directly involve the financial sector and through it the whole real economy in ways different from

loans due from a non financial enterprise whose bankruptcy and take-over by a new proprietor will rarely have multiplier macro impacts analogous to failure of major banks or to state default. (Passing on exchange risk on and risk of early withdrawal of intrabank credit based loans to domestic borrowers does not solve this problem as they are most unlikely to be able to pay at once or, in many cases, in full leaving the bank to face at least the initial shocks.)

One factor which appears general to most 1997-1998 external capital flow reversals leading to crises has received little attention in this context. It is, however, a well known one - **terms of trade** deterioration. Hydrocarbons, metals, tropical agricultural products, chips and steel have all recorded massive price falls since early 1997. One or more is significant in the external transactions of each of the Asian crisis economies, of South Africa, of Russia, of Venezuela and of Ecuador as well as of the contagion imperilled economies of Brazil and Argentina. The extent to which this, loss of import purchasing and debt service covering power (usually not of exports in the physical quantity sense) directly or indirectly contributed to the build-up of negative consciousness culminating in sudden, massive net outflows is unclear - logically, it should have played some especially with adjustment of exchange rates largely blocked whether by basic policy, levels of capital inflow or fear that devaluation while positive for the current account balance would trigger serious capital account reversals.

SHADOWS OF THE KREDIT ANSTALT – REALITIES OF FINANCIAL GLOBALISATION

Globalisation of financial markets is real. There is a direct set of roads from the July 1997 day the baht crashed and burnt in Bangkok to the September 1998 day LTCM stood at the door of implosion in Connecticut (or cyberspace?) and both the Fed and the multinational financial "Masters of the Universe" contemplated vistas of 1929 revisited (or a slightly premature Millennium Meltdown). Transmission contagion, lemming effects, even cronyism had travelled (presumably First Class) from Bangkok and Jakarta to Seoul and – via Moscow – come home to Zurich, Frankfurt, London and, especially, New York. While the immediate response may seem to be in terms of chaos theory –the flapping butterfly in New York triggering a typhoon in the South China Sea – that is arguably a matter of lack of transparency and of analysis. The global market logic and steps are clear enough looking back and could, to a much greater extent than they were, have been identified and limited by

1995 at the latest. In that sense the loss of a nail-horshoe – horse – battle – king - kingdom sequence is more aposite.

The most serious Northern impact – 'flight to quality' – is on the borderline between transmission and contagion. Experience with over expansion of lending pre lending without micro due vigilance and/or with no vulnerability testing for macro parametric projection changes logically leads to tightening up but not to a full scale credit crunch. But if the tightening reveals – or is 'seen' to reveal (whether validly or not – serious previously unrealised northern systemic or near systemic risks the lemming effect can take over and result in a cumulative credit crunch. The LTCM (short term derivative mismanagement) case is both the symbol and the largest example (to date) and its management by the Fed and the main multinational investment banks an indication both of persistent weaknesses and of differences from 1929. LTCM apparently was leveraged up to 250 to 1 at least 25 to 50 to 1 by borrowing and again 5 to 10 to 1 by dealing in derivatives or in other securities on margin. That is not – and should have been seen not to be – prudent for either the investors or the lenders. UBS pre investment study noted 250 times leverage contrasted with a UBS ceiling guideline of 30 - but recommended the investment. Further LTCM was a black box to lenders and to most investors – no more transparent than a ruling family linked Indonesian joint venture (probably less). Finally its macro parametric projection model was historically based (necessarily) with in vulnerability, sensitivity or early warning analysis as to changes on those parameters (even though 1997 outturn gave a clear, unboxed warning something was amiss). With total equity and loans of perhaps $100,000 million and underlying security face value exceeding $1,000,000 million behind its derivatives and other margin transactions it was so large its failure could have led to a Northern banking meltdown and would have led to a financial sector meltdown on northern stock exchanges. Without a reconstruction a contagion impact on hedge funds in general (a very disparate group) and ones with strategies like LTCM's in particular would have been inevitable. This is a result of "flight to quality" transmission from the South even though LTCM itself was only trivially involved in Asia and only marginally in Russia – its fatal flaw lay in projecting on the basis of – e.g. – past maximum interest rate spreads between Southern European and USA Treasury Paper which broke down in the face of "flight to quality".

The natural result of growing realisation of LTCM vulnerability would have been a further "flight to quality" effort – i.e. calling in loans to LTCM. A few institutions, e.g. UBS, would

have tried to launch a lifeboat because they were so deeply concerned (and perhaps been sucked down as LTCM sank?) and a few e.g. Barclays, Merrill-Lynch might have trusted in their collateral and sought to stabilise. But most would have tried to pull out.

The Fed did not muse on moral hazard, engage in multi week analysis or negotiation or avoid market intervention. Analogous to Hong Kong's Monetary Authority (if in a different context) and unlike the IMF it moved rapidly and massively with full secrecy before the event and relatively full disclosure at it. The largest and most involved investment banks (globally not only in the USA) were mobilised to refinance equity (90% wiping out the initial owners and thus greatly weakening the moral hazard critique). They and a second tier were lined up to provide/ensure lines of credit. Granted no public funds were used, the hand was the quite visible hand of the Fed – Alan Greenspan knows systemic and lemming effect risks when he sees them. LTCM was not to be allowed to be the new Kredit Anstalt on the Fed's watch for lack of action. Having acted to contain the damage, the Fed (and SEC) then moved on to push for new disclosure and leveraging rules in respect to hedge funds – or at least banks lending to them – in a context in which the banks are presumably more than usually willing (or even eager?) to explore such prudential regulation/pre crisis intervention for the future. The Fed also began a process of signalling against rapid credit contraction by shabing (not panic slashing) a key lending rate and stating (elliptically as usual) more would follow if needed to stabilise the credit provision system.

A side point is that this case raises doubts as to the virtues of a monistic focus for a central bank on national inflation control. For the Bank of England to have done what the Fed did with the B of E's current mandate would arguably have been improper (and thus even if agreed after dialogue probably too late). The propto ECB (and existing Bundesbank) are constrained (or at least arguably constrained) and certainly monistically focussed in the same way. This is not an argument either about accountability or independence – the Fed's independence meant it could act virtually instantly (doubtless keeping the US Treasury in the picture) and its accountability meant that it and selected financed institutions mobilised by it testified publicly and analytically to the US Congress within a week. It is an argument that (perhaps *faute de mieux*) a Central Bank must have **multiple duties/goals** – price stability, external account sustainability, financial system viability and overall macro output/employment level health – and take reasoned judgements when real or potential conflicts arise among them. One goal/one set of instruments/one institution may in principle

be optimal, but at present there are no realistic alternatives to Central Bank involvement in financial system viability and external balance sustainability pursuit nor to very close collaboration with Treasuries on output/employment level health in ways which do require it to take risks/make tradeoffs on the price stability goal.

Another Southern echo in the LTCM case is **cronyism**. "Too big to fail" – more accurately too big to be allowed to fail because of systemic impact – can be misused as a cover for bailing out "cronies" and often does raise moral hazard issues. LTCM's guiding lights were part of the multinational financial elite; major institutions and their senior officers were deeply at risk; the bailout negotiations were among colleagues and acquaintances – pejoratively cronies. LTCM's initial investors/operators are – on the face of it – only 90% wiped out when without the bailout they would have lost 100% of their LTCM stake and in several cases been bankrupted. UBS justified its proposed investment by arguing 30% of investment was by eight strategic financial institutions, a majority state owned, with windows to see structural changes in advance. One was the Italian foreign exchange stabilisation fund whose interest in financing an enterprise committed to pushing the Italian sovereign debt interest rate spread above the comparable German and USA rates is easy enough to see but not easy to regard as prudent investment on its part nor possibly to regard as conflict of interest free. But, this is arguably to scan knotholes, not even trees, much less the forest. The mistakes of analysis and judgement were appalling and were among colleagues, but to allow them to affect only those who made them was not possible. LTCM's implosion would have had systemic consequences, it could have been the Kredit Anstalt 50 years on (with Zurich's largest gnome - UBS - probably next in line) and waiting to see would have been a Monte Carlo option tremendously more expensive and possibly impossible to reverse once LTCM had collapsed. Systemic risk had to be tackled rapidly and massively even if the mistake makers did (as at top levels of globalised sectors they usually do) have close prior working relationships. A 90% penalty for error is not so low as to justify claims moral hazard was ignored and the Italian state entity investment issues can be pursued now with markets - perhaps - restabilised better than in the furnace of a lire meltdown.

The LTCM case highlights that while the main body of this paper focuses on Southern manifestations and measures, the principle arguments and lines of action do have Northern relevance and analogues. Globalisation exists and will not go away. Markets do overshoot, Lemming effects are real. Financial destruction via the market does not affect only the

imprudent, is not always creative nor self correcting and can be socially, politically and real economy (output and employment) disastrous to the point of unsustainability.

In the North the problems of overborrowing (too high short term risk and return arbitraging short term capital provision) relates to sectors and to types of financial institutions (treating Southern economies as sectors) while the problem of overlending (and then overloosing) has a much higher profile than in the South. But in the South imprudent lending by domestic banks is as central as and directly linked to overborrowing from external while the bio and info technology Northern bubbles (involving equity, portfolio and long term credit as well as short term) are in retrospect analogous to the Bangkok property bubble to bust and the LTCM black box to black hole scenarios. Similarly how to act preventatively, proactively and in crisis containment mode necessarily varies, but the Fed's LTCM intervention the HKMA stock market intervention (intriguingly focussed not only on the vulnerable financial and property sectors but within them on the largest and highest quality enterprises) are basically similar proactive operations. Regulating hedge funds via requiring lending banks to limit overall leveraging (basically a Northern preventative measure) would be similar to requiring banks to hold – say – 25% prime hard currency short term asset reserves against external currency denominated deposits (basically a Southern preventative measure).

RESERVING, REGULATING, REPORTING: PRUDENTIAL PREVENTION

The priority given to preventative action is not based on any premise that proactive and (reactive) crisis containment measures can be rendered unnecessary always and everywhere, let alone that immediate tasks are basically preventative rather than present crisis containment. The reasoning is rather different:

a. large inflows of external funds, and especially of footloose short term finance which is either risk avoiding or speculative swing maximising cause problems during **inflow** and therefore should be managed then;

b. because massive short term external indebtedness massively increases vulnerability exposure to it needs to be limited and safeguarded by prudential limits and reserve requirements before uncontrolled excess liquid finance comes in (analogous to bulkheading and stabilisation requirements for ships to limit capsizes from massive internal tidal waves as in the Herald of Free Enterprise disaster);

c. prevention therefore can limit both levels of risk and vulnerability to shocks in a way even proactive semi *ex post* measures cannot;

d. unless crisis containment is to become a repetitive series of remarkably similar but ever larger and more desperate 'one off' (in hope if not reality) measures a clear structure of prevention - proaction - and crisis containment should inform crisis containment measures;

e. indeed while there never is a perfect time to institute reserving, regulation and reporting the middle and late phases of crisis containment are quite possibly the least problematic periods for phasing them in because confidence has been - at least provisionally - been restored, most skeletons are already out of closets and resources for building up provisioning are likely to be least hard to mobilise.

The focus on reserving/provisioning, prudential regulation and reporting is partly analytical and partly political. It is the approach which is most market related. Such measures manage and set parameters for markets rather than blocking them and leave basic discretion to enterprise managers in a way traditional exchange controls do not. Similarly they are part and parcel of conventional wisdom in Northern financial actors - degrees and details not existence are the issues in real world debates. Therefore arguing that Southern economies should act similarly that global analogues (almost certainly partial) deserve exploration and that reporting should be global with reserving and prudential regulation globally coordinated is not and cannot seriously be asserted to be inconsistent with market oriented financial systems. To attack such an approach root and branch is not to challenge Mao Tse Tung and The Bank of China but Alan Greenspan and the Fed (perfectly possible but not exactly the same thing!).

The focus is largely but not exclusively on short term financial flows and ratios because most international financial flows are short term and because the potential for rapid and

unmanageable reversal of flows is much higher for short term lending (and derivative transaction) than for long term, lending let alone equity. The primary of attention given to banks and the secondary attention to other large domestic enterprise external borrowers is equally pragmatic. Banks are the largest sources and channels of inflows and - unlike, say, hedge funds or smaller finance and property companies borrowing from them - are relatively easy to identify and to require to report and to enforce prudential limits (e.g. on debt/equity ratios of their borrowers well below the 7 to 1 which was the average pre crisis level for the Korean chaibol sector).

Similarly emphasis - at least for immediate forward planning - is put on available, practicable instruments. In most South economies 100 banks and 200 other financial and non-financial enterprises account for 90% of enterprise sector external borrowing (and almost as large a proportion of domestic borrowing and lending). Therefore reserving, regulating and reporting are not inherently impracticable or so leaky as to be of little impact - albeit the mind boggling apparent $20,000-30,000 million first half 1998 Chinese enterprise asset externalisation is a cautionary note in this regard. National capital ratio, articulated reserve ratio, client leverage limit and, reporting requirements are available; international ones are not and will not be in the short to medium run. Raising interbank and other short term borrowing costs by reserving (e.g. 25% or 50% held in prime external paper or in non-interest paying Central Bank deposit accounts) is practicable and arguably can be useful. The Tobin tax (on all foreign/foreign exchange transactions whether or not real and whether or not any actual conversion takes place) on all transactions is not available, because to be effective it needs to cover most major markets, and presents major definitional, assessment and incidence/impact estimation problems.

Articulated reserving by banks and other financial enterprises and - perhaps - by non financial enterprises borrowing externally against net short term (0 to 365 day) external liabilities is central to preventative market management neo-exchange control.

Reserving against external liabilities is needed on an articulated basis by duration of borrowing and by borrower. The reserving should be by the initial foreign currency borrower and be held in foreign exchange (or readily marketable prime hard currency paper - given volatility preferably demonstrated in the same currency as the borrowings). Reserves in domestic currency and banks' passing on the currency risk in their onward domestic loans are not serviceable because they do not provide instant access reserves to diminish the risk of and

increase resilience in the face of sudden outflows. In the risk passing case they may well be ineffective in a crisis as the ability of domestic market oriented enterprises (unless literally holding take or pay contracts payable in hard currency) are highly likely to need to renegotiate at least the loan repayment period if the exchange rate plummets.

The two main methods of providing such reserves are deposits (at low or no interest) with the central Bank or by the borrower holding prime hard currency paper (basically Treasury bills or major - "too big to fail" - multinational bank obligations). Which is preferable is contextual. If reporting and regulation are rapid and effective the latter would seem more market and borrower responsibility friendly (and to lower risk of the CB being pressed to use the reverses to meet other foreign currency requirements).

A possible third option is forward hedging against external borrowing. This has rarely been practised by banks in most South economies nor pushed hard by their governments. So long as the hedge partner was a first class multinational bank (to avert the disasters when Russian hedge contracts blew up in the fac3s of external bank lenders), it may be prudent to allow banks and other financial institutions to choose between hedges and prime external assets (presumably on the basis of the opportunity cost of the former vs. the contract cost of the latter).

The main types of bank (or analogous financial institution plus insurance company) borrowing needing provisioning are:

a. foreign currency denominated deposits;

b. interbank loans and credits;

c. externally held - however denominated - debentures and similar securities;

d. forward foreign currency transactions;

e. other derivative obligations.

Except in the last two cases the amounts are determinate. In that pair however as the exchange rate will not go to infinity nor will spreads determining derivative obligation some type of exposure to liability determination guidelines will need to be established.

Distinctions are also needed between short (365 day or less), medium (1 to 3 year) and long (over 3 year) obligations with preserving highest for short and lowest for long. When there is **no crisis and no threatening inflow** of external funding 25%, 15% and 10% ratios might well be adequate. For example, 25% withdrawal or non rollover of interbank loans and lines within a year is a crisis reaction and knowing such a level of calls can be met should ensure it does not occur. Contexts are relevant to precise requirements. For example Philippine dollar denominated deposits are near or above present external reserves but are largely held by Filipinos using them as safe store of value places for savings to be used to support family members, build houses or make small investments plus companies using them to insure against exchange rate risk (or current foreign exchange earnings volatility) in respect to future external payments. These are not very volatile types of holding so the June 1997 Central Bank setting of a 25% external asset reserve against them appears adequate.

One reason for moderate base reserve levels is that in the proactive and (perhaps) the reactive stages of external capital account management/neo exchange control it is desirable to be able to raise reserve requirements at least on new obligations which cannot be done if initial levels approach 100%.

In respect to foreign currency forward contracts and to other derivatives, as noted, serious exposure estimation issues arise. In the former case - assuming banning leveraged transactions (or limiting them to 10% of unimpaired tier owe-equity-capital) - 25% to 33% of exposure at current exchange rates might be adequate. In the latter it is essential to have limits on leveraging but probably impracticable to ban it (unless a total ban on such transactions is intended which might be prudent for all but a handful of domestic financial institutions in most emerging financial market countries) because leveraging is the name of the game in commodity, stock exchange index and interest rate spread derivatives. Given the lurid light the LTCM case, throws on major multinational investment bank ability to understand/project such risks limiting underlying face value (not the lower apparent leveraged commitment) to - say - 10% of unimpaired tier are capital and reserving of 33% of that would appear a prudent first approximation.

In principle reserves levels should be **calculated net** and overall. In practice this may be imprudent. If external lending/lines of credit/foreign currency forward purchases are in currencies or to/from institutions which may be unable to deliver it is not safe to net them out. Possibly a list (based on international credit ratings) of **approved currencies and**

institutions credit balances with whom could be netted out would be appropriate. This could - should to facilitate regional economic interaction - be supplemented by common regional reserving and regulation standards with countries/qualified enterprises (based on national lists?) approved for netting out purposes.

Reserving should apply to **non-financial enterprises borrowing externally directly**. This does not require as much reporting/monitoring burden as might be supposed as in most emerging capital market economies 100 (or even 50) enterprises will account for 90% of the sector's external borrowings. The short term obligations in these cases could include confirmed trade letters of credit or could exclude **if** the commercial banks were required to provision their net forex liability position on such letters. Non financial domestic enterprises might be allowed to provision through hard currency denominated accounts with domestic banks because the banks would then provision those but that route should require higher provisioning (at least 50% when the basic rate is 25%) to limit leveraged dilution. Realistically these relatively large enterprises are quite capable of opening accounts externally with major multinational banks. Probably interest rate spreads will be low enough for an account of 25% of the next 365 days obligations at - e.g. HKSB - London to be less costly than a $ one of 50% at - e.g. Bank of the Philippine Islands (BPI) - Manila.

A special problem in respect of some non-financial institution borrowers is that of **off balance sheet potential external liabilities**. These are predominately foreign currency borrowings by external subsidiaries or joint venture guaranteed by the parent company. The provisioning against such contingent liabilities depends not primarily on the face value as such but on the risk of the guarantee being called. For example San Miguel's Hong Kong subsidiary is profitable and its debt (even if guaranteed) low risk but the same cannot be said of the China-Vietnam-Indonesia breweries which are at an initial entry loss making phase and may stay there until those three markets pick up (and/or present excess capacity is closed in China). If - e.g. - San Miguel's obligations to meet cash flow subsidiary losses are contractual, provision against them probably should be required but again real problems of likely outflow estimation arise.

Provision against non-sovereign debt logically should be paralleled by provisioning against **sovereign (including for this purpose state, regional and municipal obligations) external debt**. Presumably determining short, medium, long term obligations is relatively easy. So too would be designation of the Central Bank as holder of - ring forced - provisioning

(preferably counter-balanced by non withdrawable Treasury and local government treasury deposits with the CB paying interest - say - 0.5% a year below the average liquid external asset reserve earning rate). In these cases a more marked taper e.g. 33% - 10% - 0% might be prudent to give a higher incentive against government short term external borrowing. Certainly the greater 1998 strength of Argentina's real vs. Brazil's cruzeiro (despite significant overvaluation in both cases and a higher external reserve to GDP or trade balance ratio for Brazil) turns on a much shorter sovereign debt profile (including government and Central Bank) for Brazil.

Foreign owned domestic currency sovereign debt - which can exceed reserves when it is the principle channel of short term inflows and which precipitated (even though it did not cause) the 1998 Russian crisis - needs to be provisioned. The problem is not one of logic but of identification. Clear identification of ultimate owners at time of sale or transfer to a new holder is needed. Legitimate foreign holders should not be alarmed if the link of CB/Treasury external asset provisioning is made clear but the complexities of up to date recording if there is a substantial second hand market could be severe. Money washing transactions - external and domestic - will be deterred but that is logically a gain.

While a parallel recording system for **domestically issued foreign owned enterprise sector securities** is desirable it is hard to see how provisioning could be required. At least during the preventative phase no imposed restrictions (possibly standby for proactive or reactive phases) would appear to be desirable. Exceptions may exist if non strategic stake holdings became a major proportion of market capitalisation - say over 50%? - and also large relative to GDP and reserves. The more relevant instruments may lie in limiting leveraging (i.e. margin transactions) by all holders domestic or foreign.

Foreign exchange provisioning by itself is not adequate as a complete prudential regulation system. A bank endangered by bad domestic loans will not be well perceived by the intrabank lending market nor will it be able to perform the basic role of a bank - to provide credit to facilitate the operation of viable "real economy" enterprises. Enforceable and enforced prudential guidelines and formulae are needed. One clearly stands out - allowable degree of **leveraging by borrowers** (and related requirements as to collateral). The 7:1 net debt to equity ratio in 1997 of Korea's chaebol and the probably not much lower ratios of large sectors of Thai, Malaysian and Indonesian large enterprises are both an irrefutable indictment of financial sector regulation and of lender prudence/risk management

and also a major cause of their present financial sector crises. *Per contra* the much lower Philippine ratios - 1 to 1 is considered plausible, 1.5 to 1 marginal and 2 to 1 alarming for large non financial enterprises other than public utilities and to a degree property companies - say something in favour of its public regulatory and bank prudential systems and in large part explain its significantly less acute banking sector strains.

Presumably articulated guidelines are needed. For some types of financial institutions and public utilities (especially those with inflation linked take or pay contracts) up to 3:1 may be prudent. Elsewhere a 1.5:1 or 2:1 ceiling might be appropriate. If pre regulatory reform actual levels are significantly higher a phasing in would seem appropriate especially during a preventative phase - reducing vulnerability to and increasing resilience against future shocks not creating an immediate crisis is the goal.

As with banks, special problems arise in estimating basic risk (and therefore underlying debt/equity ratio) in respect to **forward transaction/derivative operations**. However these are estimated, a ceiling ratio of 3:1 of total assessed liability to equity to be eligible for bank finance would appear prudent even if this did deter legitimate and non Monte Carlo enterprises. The risks to lenders of true leveraging of 50 to over 100 to 1 (cf. LTCM) are so high an emerging capital market regulatory system should probably err on the side of systemic risk limitation. In cases like Singapore and Hong Kong perhaps lists of approved borrowers up to 5:1 could be built up but many regulatory systems have little capacity to do so and more urgent tasks to undertake.

Leveraging limitation via banks (and capital market issues - which will normally involve banks as managers, underwriters or trustees) is a first step. Since bank credit or bank involved bond issues are the main sources of borrowing it can be substantially effective by itself. But it needs at some point to be complemented by mirror rules for borrowing enterprises, perhaps with an initial cut-off level of borrowing above $1 million to limit cases to efficiently monitorable numbers. As with banks phasing in would be appropriate to solvent (and not currently badly illiquid) enterprises - strengthening not flattening is the aim.

Security transaction regulation logically would centre on **margins, short sales and derivatives**. There is, on the face of it, no reason to limit regulation to external entities as the volatility and systemic risk problems are not limited to their transactions. Further, since it is lenders. brokers and exchanges who can be regulated directly, across the board rules are

simpler to operate whereas external entity only ones would entail checking multiple intermediary structures quite apart from causing clashes with Northern governments as well as institutions.

The maximum margin allowed on security purchase - including long (call) and short (put) transactions as a preventative measure should be 50%. That would reduce the risk of investor/financial institution bankruptcy in the face of margin calls (on purchases, longs and shorts) and greatly reduce the leveraging (to 1 to 1) thus making highly speculative long or short operations less attractive. Long **or** short - bubble prices from long speculation via calls is, like excessive inflows of short term external funds, to which it may be related, a problem in itself as well as in the vulnerability to subsequent shorting (putting).

"Naked shorts" (no contract to cover delivery of shorted security either by ownership or forward purchase at time of shorting) should be forbidden as should "lending" (by transfer on nominal purchase agreement - not so nominal in the event of shorter default as some investors in Malaysia have discovered) of securities by financial institutions to cover them.

Securities markets and their member traders (as well as lenders) would be the practicable control points. They can be required to secure data to ensure that not under 50% of the cost/face value of the security/derivative is paid, not borrowed. Some leakage can arise with foreign firms whose external borrowing cannot be checked adequately, but probably not enough to render the approach nugatory.

Such measures would limit the growth of securities market transactions; drastically for shorting and longing. That may be an acceptable price for reducing volatility, systemic collapse risk and scissors type external speculation against exchange rates and domestic securities as in Hong Kong in the third quarter of 1998. Measures like these were implemented in the USA in the 1930's (in response to/to prevent the recurrence of) the 1929 crash and were not fully phased out until at least the late 1960's. Some are in the process of being introduced in Japan. If the USA viewed such measures as prudent for over 30 years after 1929 it is hard to argue against them in principle as preventative devices in much narrower, shallower, less transparent and institutionally weaker markets. Given twenty year past - and probable twenty year forward projection - emerging market volatility and the real risk of betting on crises speculation and lemming effects, a 50% downpayment level also appears prudent (especially as it could be reduced to 25% if greater breadth, liquidity and

stability were to emerge and last. The USA deposit requirements were gradually reduced from 100% to 75% to 50% to 25% before final abolition).

Reserving, especially on doubtful loans, may in some systems be a major reform requirement for banks as may be equity and tier two capital (highly subordinated long term debt) to risk asset ratios. Here best practice - whether BIS or Fed or Hong Kong or Singapore guidelines - are a logical starting point for contextual adaptation and articulation. In general emerging capital market banks will need higher provisioning and equity/second tier capital to at risk assets ratios than Northern ones (and BIS standards). As a first approximation 5% reserves against loans plus 50% against problem (over 30 days in arrears on interest or principal) and 75% on 'bad' (debtor in protection from creditors, together with bankruptcy or liquidation) ones might be prudent as would a 10% capital (excluding problem/bad debt reserves) to risk weighted (e.g. 0% USA Treasury bills to 100% defaulted loans to entities in liquidation with few assets or similarly placed bankrupt individuals) lending.

Once required reserve/provision levels pass some threshold - perhaps 10% of gross loans - supervision on a case by case basis is needed to achieve orderly, timeous removal of both the bad or partially bad assets and the provisions against them from the balance sheet. Letting both lie there certainly creates an impression of fragility and is likely to encourage vain hope nursing or waiting for something to turn up in the case of hopeless borrowers. However, strict, inflexible time deadlines are unlikely to be appropriate because the options of foreclosing on collateral, forcing bankruptcy disposal, putting in an administrator and manager, facilitating a reconstruction (including new equity injection but also, quite probably, some debt to equity conversion and possibly additional total exposure) will each be appropriate in some cases and each has a different time scale for loan write-off, writedown, return to good status so that detailed supervision is needed. Any large financial institution in such straits does need close monitoring to avert - or act rapidly in the case of - further deterioration.

There is no technical reason the preceding reserving and prudential regulation system (and the data to make it work) could not be built up in 2 to 5 years in most larger and middle size emerging market economies. Advice on structure and legal form, special training for current Central Bank/SEC/Treasury regulatory personnel and new domestic professional recruits and some initial expatriate staff are likely to be needed but neither the design, the legal, nor the

personnel side should pose insurmountable obstacles if a genuine government priority to action exists.

Other aspects of regulation including on limitations on concentration of loans, on share of equity in total assets (or relative to bank equity), on constraining lending to bank owners and associates and on fraud detection and revealing to regulators are again areas in which external best practice can provide a starting point. They may require substantial contextual modification in countries in which banks (and insurance companies) are members of corporate families but modification should not mean waiver. For example if the insurance company in the Philippine Ayala Corporation group lends 10% of reserves to main Ayala companies and 5% on mortgages to property purchasers from Ayala (or vice versa) this may be prudent but were the shares 30% each it would not be. In such country and financial enterprise cases, there may be need for special provisions as to independent directors, external audit and direct transmission of audit results to regulatory authorities.

Requiring reserving (external and overall) and prudential management (including limitations on leveraging) both require and are facilitated by **transparency**. Unless data are promptly and accurately provided to regulators (and checked by them in cases of doubt) the system can neither work nor, for very long at least, be perceived as working. **Unless at least macro and sectoral data are published promptly the system is unlikely to be fully credible**. If they are then observation of their levels and trends will provide reinforcement to prudential (crisis preventative) behaviour by lenders and borrowers alike.

A major argument against disclosure has been that it would **precipitate a crisis** rather than prevent one. That is a matter of timing. Had Thailand introduced transparency in May 1997 (including its mortgaging of up to 90% of Bank of Thailand reserves in forward transactions) doubtless the July crisis would have come immediately. Had it done so in May 1992 - when most of the excess short term inflow, the resultant domestic overleveraging, the property bubble and the mortgaging of B of T reserves had not yet taken place - it should have averted or significantly limited all of these trends. The B of T, the Treasury, lenders and - probably - borrowers would have behaved more prudently and the property bubble would have been much smaller (e.g. like the Philippine case in which the main property companies are reporting radically reduced profits and net cash flows but profits not losses and lower interest and repayment cover but still over 1). **Either pre crisis or post crisis is the time for**

introduction - just before or during is in fact likely to be impracticable because of other needs and just before might also in the absence of earlier transparency hamper proactive measures.

Both reserving and prudential regulation should be transparent regionally and globally. The logical regional coordinators/publishers would be associations of central banks although regional development banks - as clearly independent institutions - are alternative publishers and globally the IMF (or the World Bank if it is desired to differentiate between publishable data and other information provided to IMF teams which financial and commercial prudence might suggest should remain confidential) - albeit in both cases this would require substantial upgrading of present guideline setting and monitoring capacity. Logically **some minimum level of transparency** (and of prudential regulation and reserving) should be a **threshold below which access to new/additional Fund drawings was denied** or at least made preconditional on an agreed set of measures and a timetable for implementing them. Both the transparency and the potential fund ineligibility without it would deter worsening of structures and vulnerability via excess inflows albeit non transparency and ineligibility would raise the risk of precipitating a crisis if they were believed to indicate a situation worse than reality.

Deposit insurance is a means of reducing likelihood of and levels of mass domestic withdrawal surges and may make it both less likely that banks will fail and less crucial to 'nationalise' their net deficits if they are in danger of doing so. Guarantees of - say - 100% up to $10,000, of 75% between $10,001 and $20,000, of 50% between $20,001 and $50,000 and of 25% thereafter up to $1,000,000 would (especially since households and enterprises will 'diversify' banks) reduce the panic withdrawal threat and the risk of national small savers' wipe-out and resultant social unrest. That could be strengthened by two additional provisions:

a. **bust banks will be taken over by a reconstruction, sale and liquidation agency** (as used by the USA in its savings and loan crisis) which would either pass on/sell off good borrower loans and parallel liabilities to sound banks at once or operate the 'good asset bank' contained within the bust one to avoid an interim credit crunch and to ready it for resale while dealing with bad assets/borrowers in a separate wing. This approach will

normally wipe out or near wipe out former owners so is relatively immune to moral hazard objections;

b. **repayment of the deposit insurance agency** will rank as **co-first priority claims on assets recovered/entity sale proceeds** together with tax liabilities and employee compensation; the balance of deposits and agency operating costs as co-second priority claims and all other liabilities (including interbank loans and credits even if secured) as co-third priority. So long as external bank lenders are not treated worse than domestic there is no self evident grounds for IFI or other general Northern objection.

The snag with such deposit insurance proposals is **initial finance** for the insuring institution to achieve initial credibility. If it charges 1% a year on all deposits it will take 8.1% years to build up a ratio of 10% reserves to all deposits (perhaps 12% to covered ones) even assuming no net calls at all on its resources over those 8 to 9 years. The only apparent modality would be to provide a Central Bank line of credit to be repaid from asset/enterprise disposals (which might take 3 to 5 years) and subsequent annual premiums on deposits. A possibility, at least for smaller and lower income economies, might be to convert IMF's ESAF (now a rather odd and unsatisfactory mini IDA) to a Financial Sector Reconstruction Facility and/or to use World Bank financial sector loans for this purpose.

PROACTIVE RESPONSE: RESTORING SUSTAINABILITY

Proactive in the present context does not relate to action after the turning of the external inflow tide, but to periods when it has become **unsustainably high and action is needed to avert (or to limit) a future outflow crisis**. In general, therefore, it is desirable to focus on tightening up the reserving and prudential regulation instruments of the preventative period i.e. make inflows - especially short term inflows - less attractive to lenders (buyers) and borrowers (joint ventures) alike. However, complementary measures and uneven increases in reserving and regulating measures may be appropriate if the impact of inflows is problematic in only a few sectors. So too may be specific - largely Central Bank or Treasury - interventions to **lengthen external debt profile** and increase liquid external reserves. In cases in which an outflow crisis comes to appear inevitable prior negotiation of an IMF Standby Agreement (in the original and literal sense) and (by the financial sector as well as the state) of external (governmental and bank) lines of credit is also likely to be appropriate.

At this phase controls on outflows or moratoria - indeed official public discussion of them - are likely to be inappropriate because of their propensity to cause and to exacerbate tidal wave outflows whereas lines of credit and standbys tend to increase confidence both because of the funds they make available and because the fact of negotiating them suggests policy and practice are alert and in control.

Determining when inflows have reached unsustainable levels requires the implementation of the data collection and transparency requirements proposed earlier. These are needed to have a timeous picture on what external capital account inflows, outflows and stocks are. They are also important in facilitating both a general dampening effect on flows and use of Central Bank/Treasury moral suasion on financial institutions and major new financial corporate external borrowers.

In this phase regional and global coordination may become more important. This is especially so if the conditions/dynamics threatening to build up to a crisis are widespread among countries in one region, but not universal so that standby pre-positioning can be negotiated between the external reserve/balance stronger countries of the region and those threatened. Howard it is also true globally - international transparency standards and reporting may have limited effect on euphoria during early build-up of flows, but could be expected to be more closely observed and reflected upon as flows built up. They could also form a backdrop facilitating standby arrangement negotiation by more prudent inflow recipients.

Regionally coordinated measures need not - usually should not - be identical. But neither should they relate only to direct national vulnerabilities, stage two knock on (or knock over) effects from the most vulnerable will be significant if intra regional economic interactions are substantial. For example as of early 1997 Thailand, Malaysia, South Korea (less evidently) Indonesia were at major, imminent risk. The Philippines - at least directly - was less so because of lesser inflows and less overinvestment while Hong Kong's direct problem centred on its property market bubble. But Hong Kong, Singapore and - to a lesser degree - Taiwan were severely at risk from loss of exports to or major devaluation by afflicted economies. China, Japan and Australia were at risk for similar reasons and both had potential to, and economic self interest in, building up a standby safety net to limit intraregional trade (including their own exports) collapse as a result of a credit crunch.

On **reserving, provisioning and regulation higher levels not new instruments,** are likely to be appropriate. For example 50% instead of 25% and 75% instead of 50% on specified types of external liabilities, or more specifically new ones (gross new, not net, to increase average reserving on rollovers) should help cut back on unsustainable inflows. However, under certain circumstances reserves required against medium and long term obligations might not only be increased but even decreased to enhance incentives to restructure toward a long term external debt profile.

In parallel **debt/equity ratio limits for new credit** (internal or external) might need to be tightened and allowable margins reduced (downpayment proportion increased) on security (including derivative transactions). If an outflow crisis and/or a recession were viewed as inevitable then - but probably not before - reserve requirements against net additions to risk weighted assets should be raised as at that point non-performing loans will inevitably rise.

Negotiation of Standby Agreements with the IMF in the absence of any immediate need or desire to draw - as the Philippines did in the second quarter of 1997 and again in 1998 - may have a useful prepositioning and prophylactic affect in respect to outflows. Whether they would cause reappraisal of levels of current lending is unclear. Negotiation - by Central Banks, Treasuries and financial institutions of lines of credit with Central Banks, government agencies and multinational banks - would have similar prepositioning and prophylactic impact to IMF standbys but potentially greater tendency to reduce other levels of net multinational bank lending.

If an outflow crisis appears inevitable Treasuries and - to a lesser degree - central Banks and banks may benefit from **external debt profile lengthening/reserve enhancement measures**. These would involve new medium and long term borrowing used to reduce short term liabilities and/or enhance reserves. Argentina and - to a minor extent - the Philippines did this in early 1998 but Brazil's parallel and later borrowing to enhance reserves was itself short term and therefore much less effective as a subsequent external liquidity profile and external confidence enhancing measure.

If proactive measures do not appear to be having a significant impact on restoring net inflow levels to sustainable trend paths, **preparation for a reactive crisis containment stage** needs to be begun, so that measures at point can be prompt and seen to be characterised by prudence rather than panic - both unlikely if they have to be devised, evaluated and

introduced unpreplanned in the teeth of a crisis. That preplanning, at least in detail, is probably an exception to the desirability of transparency. The transparency which **is** desirable in respect to crisis measures is globally and regionally agreed criteria to validate and instruments to impose temporary repayment freezes, transfer delays and moratoria with a view to restructuring.

During both the preventative and proactive phases the case for direct Central Bank intervention to alter exchange rate trends is limited. Genuine smoothing to limit apparently erratic fluctuations and possibly day limits of - say + or – 2½% (which triggered shutdown of wholesale - not retail currency exchange) in effective rates can be useful. In the case of a clear creeping overvaluation trend (or canter if the nominal rate shows signs of rising) there are arguments for a Central Bank policy of issuing paper partially to sterilise liquidity (and thus inflows) with the proceeds invested in highly liquid, low risk external assets (not futures contracts a la the Malaysian or, earlier, Malawian Central Banks nor hedge funds a la the Bank of Italy). However, continued need to follow such a policy suggests a need to tighten up on reserving and/or provisioning.

In respect to **outward capital account exchange control**, the preventative and proactive stages are - by definition as excess inflow is the problem - not ones in which tightening is appropriate. If there are pre-existing capital account exchange controls, **how rapidly they should be attenuated** is a contextual, empirical question not one of ideology. To pose major (and especially increased) barriers to external investment outflow does discourage external capital inflow, but is hardly consistent with seeking optimal (as opposed to nil or very low) inflows nor to facilitating their direct mobilisation by the enterprise sector rather than their concentration in sovereign or sovereign guaranteed debt. Similarly to bar or severely restrict external investment by domestic enterprises either bars them from participating effectively in regionalisation or globalisation or constrains them to leverage their external operations to imprudent levels (possibly with non-transparent, off balance sheet guarantees which become visible only in the glare of a financial conflagration). In respect to other capital transactions - including portfolio diversification and capital flight narrowly defined - three comments can be made:

1. tight regulation poses grave inconvenience for legitimate small transactions or - with currency convertibility - simply pushes them into foreign currency buying channels;

2. with relatively free trade and convertibility of currency, small to medium transactions concealed in these channels cannot be prevented if bans or high transaction cost exchange control exist;

3. focused surveillance to identify - and forfeit - money laundering and corruption based transfers would have more useful systemic effects and be more effective (because more focused). The lowest cost, most user friendly form of portfolio currency diversification for most individuals and for small and medium enterprises is likely to be hard currency denominated deposits (in practice $ deposits with DM ones of some significance in Central Europe). If properly reserved with liquid external assets these are also the safest 'external' (external currency denominated) liabilities and the ones least likely to surge out in a crisis. Therefore, the case for **domestic hard currency account access as an early attenuation of existing capital account exchange control** is strong.

REACTION AND RECOVERTY: CRISIS MANAGEMENT

Ideally preventative action would create market conditions averting unsustainable inflow levels and composition while prudential regulation would avert systemic risk build-up flowing from financial and other large enterprise imprudence. As a second line of defence, when proactive measures flows/levels came to be seen (by the importing country Central Bank/Treasury) as unsustainable would either avert a real outflow crisis or lay by significant enough reserves and lines of credit and a prudent enough external debt time profile to ride out any temporary outflows.

Unfortunately while certainly reducing the number and severity of crises the proposed measures cannot inoculate fully against them for several reasons:

1. even if markets are fully rational they are - and will continue to be - limited by incomplete and or erroneous information and by lumpy flows of new information;

2. the quantity of information (of varying quality and comprehensiveness) now available is so large that effective retrieval, analysis and prioritisation is very difficult;

3. the link between information and action - perceptions - has a tendency to stickiness followed by sharp changes i.e. inflows will overrun rational levels until increasing perceptions of risk finally generate a turnaround which may be very sudden and is equally likely to overshoot through stickiness;

4. perceptions and perception changes tend to bunch because financial institutions seek not simply good performance but equally avoiding performances worse than those of their rivals so herd in and stampede out in a way inherently likely to exacerbate volatility even when excess volatility does not serve most main actors' interests;

5. shocks - e.g. commodity price savings, specific industry overcapacity, key external market evolution (especially divergence from projections), in some emerging financial market cases weather or other national disaster, socio political implosion or confrontation, key (at least symbolically) enterprise collapse - do and will occur. They do - especially cumulatively - alter economic reality (financial and real) and often alter perceptions (domestic and external) even more.

Therefore there is a need for pre-articulating a third stage of capital account management - reacting to crises which have begun in order to restrain their scope and to limit their duration.

The first issue is defining **what constitutes a crisis**. Depending on domestic savings levels, outward investment and previous projected sustainable inflow rates a small outflow may or may not constitute a crisis. A rapid swing from net inflows over 5% of GDP to outflows almost certainly does constitute a crisis, whatever reserve levels are, because the shift in perceptions behind such a swing is almost certain to carry it further.

The second issue is to decide in advance **how long or far** (in quantitative terms) to go with using official and institutional reserves, with drawing on external official and financial standbys, with market smoothing (e.g. closing trading for the day after a maximum 2.5% one day exchange rate shift) and with raising discount or analogous rates to levels which if held to beyond 30-60 days will have serious financial institution non performing debt and real economy recessionary impact. To begin with no set limits before taking more draconic action is likely to result in excessive dumping of resources into a whirlpool and of imploding the domestic market (first by reducing fixed investment and second by consequential domestic consumption compression).

Determination of limits does require specific attention to pre crisis exchange rate (overvalued? by how much?) and inflation (how high? trend?) positions. If the currency is 10% overvalued allowing it to fall 2½% a day for 4 days with no intervention until the last may be prudent - may because a sudden exchange rate fall tends to overshoot. Similarly higher inflation rates justify higher nominal interest rates and - in the presence of fiscal imbalance - expenditure pruning and/or phasing and perhaps increased taxation. The 1997-98 position has been dominantly one of clearly overvalued currencies - with the pre crisis exception of Indonesia - but the inflation and fiscal balance positions have varied widely.

A **possible set of limits** (assuming limited overvaluation inflation with current fiscal and account balance or surplus and investment financing requirement net over 3% of GDP) could be:

1. deployment of up to 10% of initial Central Bank/Government and financial institution reserves plus 25% drawing on pre-negotiated standbys;

2. allowing devaluation of 10% over 4 days (plus a closed weekend) with limited smoothing intervention;

3. subject to "1", intervention to contain the exchange rate slide to 15%;

4. setting of discount rates at 5% above inflation raised to 15% if necessary but with a limit of 60 days for rates substantially above 5% real (because of domestic financial system stability and real economy recessionary impact.

During that period the goal is to **ride out the crisis with secondary adjustments using reserves, standbys and temporary draconic monetary policy**. The **transparency** target is to present the underlying data and trends plus policy in place. The **limits should not be publicised and the question of fallback positions and instruments** (other than extending face amount of and drawing on standbys) is **probably best not articulated in any detail**. If an international consensus on suspension and rollover to allow renegotiation/restructuring has been reached it would be unconvincing to assert it would never be used, but probably undesirable to say exactly when, how and under what circumstances. Transparency focused on actual reserving, provisioning and leveraging (limitation of) may except in the most virulent crises convince major financial institutions and investors who - even if their credit is short term - are in for the long haul to reflect, review and perhaps halt capital pullout. That

depends partly on how virulent contagion is, what other shocks more specific to the particular economy have happened and how convincing the pre crisis transparency record has been.

Once the limits are reached a set of **suspensions, rollovers and renegotiations** - involving Central Bank/Treasury/external financial institutions/domestic financial institutions and other major externally borrowing enterprises - is appropriate. How readily a government should reach for this option - or complementary/alternative modes of direct intervention - depends partly on whether present global dialogue does reach a *de facto* consensus of the acceptability of external capital account payment suspension followed by inclusive roll-forward, and/or restructuring negotiations.

The suspension/rollover should **focus on external short term liabilities and on banks because the former pose immediate problems** (before time to adjust or to alter projections) and the **latter are usually the largest and most volatile capital flow channels**. In respect to medium and short term external liabilities - except sovereign debt which should be serviced if at all possible including drawing on standbys - suspension of payments due during the 90 days with payment to be made immediately thereafter or (on a negotiated basis) phased over the next two quarters should be adequate if no major borrower liquidity or solvency problem exists. Interest and - if possible - dividends (because they are current not capital account) should be paid.

The 90 days should be used to negotiate:

1. agreed rollover of short term lines of credit/interbank loans/analogous debts due over the 90 days and the next 365 days - ideally 100% rollover but - depending on reserves and current account foreign exchange flow projections - at least 75%;

2. restructuring of short term debt to medium term obligations in cases (micro) in which clear illiquidity but probable solvency on a going concern basis pertain;

3. more radical restructuring (probably with Chapter 11 type bankruptcy or administratorship protection) in cases of insolvency or extreme structural enterprise illiquidity;

4. negotiation of additional IMF, external government or international bank consortium loans if projections suggest these will be needed or be prudent to have in order to allow a safety margin and improved external perceptions.

If commercial banks are concerned to achieve speedy results or particular forms of restructuring because of their national problem loan/risk rating/reserving requirements, so long as the overall negotiated package is acceptable these concerns should be accommodated. Illiquidity case negotiations should, at least in outline be capable of being completed within 90 days but potential insolvency ones will take longer. However, the basic objective should be to have rollovers, restructurings and standbys adequate to allow ending overall suspension by the end of the 90 days. The remaining enterprise cases then do not represent government default or state default but the standard problem of creditors at risk because of debtor results. Whether this is possible depends partly on national institutional, data and personnel capacity and partly on with how many countries the IMF, bilateral government instrumentalities and financial institutions are negotiating (external financial crises tend to cluster).

As well as balance sheet liabilities, **confirmed letters of credit** (their continued acceptance by external banks) need to be addressed. Basically the goal would be to guarantee a base level consistent with normal external trade - and especially normal export, food supply and fuel sector - requirements. A desire by the external banks to exclude clearly weaker domestic ones cannot - if based on real risk of insolvency - be rejected out of hand as long as a floor level of clc's agreed e.g. by raising the ceilings for a limited number of stable domestic and deep pocket domestic/external joint ventures or multinational bank subsidiaries.

Renegotiation probably needs to be divided into two clusters: bank and analogous financial institutions and other enterprises. The reasons are that **main banks/the banking system cannot be allowed to fail** (at least without some deposit protection and successor provision) and that, as a result, a much more hands on government role in credit provision level negotiation and in reconstruction is unavoidable.

In the case of non-bank enterprises the appropriate frame is a Chapter 11 Bankruptcy/Administratorship legislative regime supervised by - e.g. - a strong Securities and Exchange Commission with access to the courts. Clearly this cannot be created instantly nor is it needed only during external crisis - creation and running in a domestic policy parallel to the preventative stage is appropriate.

The renegotiation toward recapitalisation, restructuring or liquidation should be pragmatic with its goals continued operation of viable productive capacity (and associated employment) and maximising the medium to long term value of the operating plus sold off assets to reduce losses to creditors/investors/employees. This may involve new capital from existing and/or buy in owners, conversion of debt (to equity or convertible "tier two" subordinated debentures), sale of core enterprise as a going concern with agreed asset and liability package and/or liquidation (in whole or part). Government involvement should be as a frame set and mediator (separated from any government unit interest as a creditor or shareholder which should be presented separately like that of any other claimant).l

In the case of **banks** there is a more complex and direct state interest:

1. to **protect depositors**;
2. to **avert liquidation** of good banks; and
3. to **ensure continued credit access** for good borrowers (even when initially customers of bad banks);
4. to **avoid overall banking system meltdown**; while
5. **limiting moral hazard** by putting all actors, except small depositors, at real risk and forced to pay a real price in reconstruction or liquidation cases (the state would pay through unrecovered deposit insurance and recapitalisation contributions).

To achieve these aims a regulatory and monitoring/reporting structure under the Central Bank, a Financial Institution Authority or The Treasury is needed. Its putting in place - or strengthening and extension where existing - is a domestic parallel to the preventative phase on capital flows.

Where practicable negotiated reconstruction including new equity capital by existing or additional owners and possibly conversion of some loans into tier two capital (subordinated convertible debentures) is often the best course. It may involve a foreign partner (or foreign buyout) or a merger. However, a merger makes little sense unless one bank is both solvent by a significant margin and relatively liquid and the other (or at least the portion transferred) basically solvent and only moderately illiquid. Otherwise the result is likely to be the generalisation of weakness. In merger cases beyond Central Bank lender of last resort

liquidity (**not** solvency) advances, the only appropriate state financial injections would appear to be second tier capital (e.g. convertible subordinated debentures).

For banks which are both illiquid and either insolvent or at real risk of becoming so, much more radical measures are needed. If good assets and operations can be identified these plus deposits and a balancing capital injection can be sold to a sound bank. In that case the rump bad assets would go to a "bridge" or "bad" bank to liquidate and to use the proceeds to pay off the deposit insurance agency, lenders and other creditors (on a preset priority schedule set out earlier).

In that case the equity holders and probably old tier two capital holders will be wiped out. The interim asset transfer would presumably be medium term government paper with discountability at the Central Bank but possibly with limits on other sales for - say - 3 to 5 years. That paper would be a priority claim on the "bad" bank's proceeds and its counterpart value an asset of the Deposit Insurance entity.

In the case of banks which were fairly clearly insolvent with no easily separable 'good' section to transfer the "bad" bank would need to take over in order to manage with a view to liquidation or reconstruction for future good assets/operations sale analogous to the USA Saving and Loan exercise. Operation is needed both to give depositors continued (or quickly renewed) access to their funds and to avoid 'good' borrowers from 'bad' banks being strangled by lack of access to credit. If - as may often be the case - the bank management capacity of the agency is very limited, it may need to transfer deposits, good loans and gap filling government paper to sound banks as rapidly as possibly or to hire contract management from sound banks (external or domestic) to augment its own capacity.

Even with substantial write downs and restructurings on loans and lines of credit together with conversion of part of debt to equity or tier two capital, a substantial to massive cost to the state is likely. Even in the USA Savings and Loan case the cost was nearly 5% of GDP while in the Mexican 1995-97 reconstruction it was 14% of 1997 GDP (albeit with relatively low external lender 'participation' in loss and relatively non-energetic pursuit of 'problem' loans transferred to the state agency. So far as basic asset adequacy goes limited short term marketability government securities may be serviceable with conversion of a portion of non-written down loans into tier two capital and equity from the new owners that approach should

result in reasonably respectable balance sheets. For liquidity funding the CB's standard role of lender of last resort remains appropriate.

At some point in this process bad debts and parallel provisions should be written off. 30% bad loans and 25% of risk weighted asset provisions looks, and to a lesser extent is, much worse than 10% bad loans and 5% provisioning. This type of cleaning up can readily be included in cases going through the 'bad' bank and - less easily perhaps - in negotiated reconstructions involving loan writedowns or conversions. It is - ironically - probably hardest to achieve in solvent banks needing only limited CB liquidity support. However, continued CB access could be linked to agreement on a time bounded project for writing off bad assets and provisions.

Non financial (and minor financial) enterprise reconstruction and/or sellout and/or liquidation is a related but separate - preferably in regulation and administration as well as conceptualisation - requirement. The state should make plain that it accepts no liability to creditors or equity holders, domestic or foreign, because no public interest arguments analogous to interest of depositors and macro economic consequences of central financial institution meltdown exist. This implies it should not guarantee the exchange rate for external debt or principal service on such obligations (or on bank lending/lines of credit for that matter) as part of a general renegotiation and external debt restructuring.

There may be a need for the government to negotiate **external lines of credit/clc cover** for domestic non financial enterprises during a reactive crisis containment phase. If the realistic, rapid sources are external governments, regional development banks and the World Bank the government will need to act as intermediary and - in practice - assume the obligation to repay. It should not, however, set itself up as a commercial bank or a grant giving foundation. Commercial banks should on-borrow and - on their own credit risk evaluation - on-lend. The only risk the government need take is part of the foreign exchange risk since while on-lending should be denominated in the underlying borrowed currency this may need to be waived in part on domestic currency receipt flow enterprises if the currency falls radically. This writedown may be avoidable if the loan is restructured to medium/long term with an interest only grace period. Certainly the state/banks should insist that such loans - necessary for continued operation - should have preferred creditor status in the case of subsequent reconstruction and, if necessary, take legislation to entrench that status. Clearly this exception can cut significant government funds/foreign exchange flows at risk and is an

indirect involvement in private enterprise investment. Its justification is quite simple - to risk working capital loans is often less risky than to risk meltdown of sound (including export) enterprise production exports and finance (including tax payments) because of a credit crunch.

During the reactive period **levels of foreign exchange asset reserving and - if write-offs take place - provisioning are certain to fall** for both financial and other enterprises. In some cases - net new foreign currency deposits and/or lines of credit - 0 or 5% initial reserving might be prudent as during this stage unduly high inflows are most unlikely. In other cases some reduction is probably inevitable but oversight is needed because falling liquid external asset/short term external liability coverage will by itself negatively affect foreign perceptions, negotiations with debtors, pressures on the capital account and duration/depth of the crisis.

Portfolio investment should not be restricted either as to conversion from one security to another or into other forms of domestic assets. Nor should remittance of interest and dividends be restricted. Except under unusual circumstances, **expatriation of portfolio sale proceeds should not be blocked** (by the time blocking is appropriate most will have gone and portfolio investing funds will probably be more cautious than bankers about returning) and at most for 90 days as part of a general suspension.

Margin requirements (including on puts and calls) should go to **100%** (i.e. 0 leverage) as soon as entry into reactive crisis management mode is adapted. The requirement for derivatives should be analogous.

Direct Central Bank/Treasury security market intervention is a last resort probably justified only if market shorting/exchange rate shorting are being run as a coordinated speculative pincer movement (as in Hong Kong) and then only for limited (stated) objectives, up to (unpublicised) ceiling amounts and in good quality paper. A more general tool could be **moral suasion** on long term liability matching by investors e.g. pension funds, life insurance companies, social security systems, Post Office Savings Banks. They could be encouraged to engage in selective purchases of existing (or additional recapitalisation) issues of solvent companies with good appreciation prospects during recovery and of medium to long term government paper. If **moral suasion** had been applied during the **proactive period not to invest in property companies and to restrain mortgage lending,** it would probably be

appropriate to withdraw the suasion - to a neutral position unless property prices had collapsed below plausible medium term levels. Rollover or lengthening of mortgages on which the borrower could clearly pay interest but needed more time (and recovery) to meet capital repayment would also be appropriate moral suasion on them and on banks - a wave of foreclosures and fire sales against solvent but illiquid mortgagees serves nobody's interests.

Externally denominated accounts (in practice $) **should not be blocked**. If it is thought necessary to encourage/pressure exporters to maintain normal repatriation of proceeds this can be facilitated by encouraging their deposit in domestic $ accounts usable for any current account external (and any domestic) transaction. By removing the exchange rate risk and reducing the multiple conversion cost this should be much more acceptable than forced conversion and reduce incentives to hoard forex abroad or to prepay for imports. Any such regulation should be withdrawn as soon as the crisis abated e.g. 180 days renewable. To be relatively equitable and effective, such regulation would need to be based on historic patterns of direct payments abroad from proceeds and of external balances (notably reserving from the preventative period!) and set - perhaps - as a % of export proceeds to be repatriated (and converted or placed in domestic $ account) within X days (again related to historic on export, on delivery 90 day or 180 day bill payment pattern). Given that 80% to 90% of exports usually come from 50 to 150 enterprises this is not inherently impracticable if planned in advance. It is, of course, a feature of old style exchange control, but does relate to capital account and - with the allowability of domestic $ accounts and current transaction use - is in a relatively liberalised, market compatible form.

Existing **direct private investment** needs to be stabilised and new sought during crisis periods. In particular continued financing for viable - if completed - projects in progress is needed to avoid their becoming write-offs dragging down operating companies and investment banks (e.g. Peregrine) and seriously damaging lenders. Clearly not all in progress ventures should be completed - e.g. new chip plants - others should be redesigned to a smaller (at least initial) scale and many with under - say - 25% of investment cost committed (including deposits and contractual liabilities as well as work done) should be postponed/mothballed.

Direct investment continuation is one aspect of credit structure and future flow renegotiation during a 90 day suspension (or without one if the negotiation can be in the context of substantial bank line of credit rollover and continued CLT acceptance as in the Korean case).

Beyond projects in progress, new long term direct investment (loan and equity) is unlikely to be large except in the context of external purchases - partnership or take-over - of existing firms and of associated guarantees of new external loan finance e.g. GEC's expansion in hire purchase by take-over of Thai finance company portfolios.

In practice take-overs by bankruptcy and/or liquidation, as opposed to negotiated settlements, are less than likely unless the state (usually via a bad bank/bad financial institution scheme) has first 'nationalised' the assets (as in the GEC case). Buyouts of pre-existing and buying into new joint ventures (as in Korea) seem more likely.

This is an area in which **state facilitation largely means not blocking** by rules seriously hampering dfi and/or negotiated bankruptcy settlement under the general surveillance of regulatory commissions and **courts which are prompt, proper and predictable**. All three p's are key - e.g. the Philippine courts at this level are proper but - because of the plethora of reviews possible - not prompt and are perceived to be unpredictable. There is no case for the state as such recapitalising non financial enterprises nor for it (as opposed to regulatory commissions and courts) judging the equitability to domestic investors of external capital restructuring/buyout proposals. Exceptions on macro or regional (sub national region) grounds should be very few and far between especially if the external purchases proposes to operate the acquired enterprise on a substantially comparable scale. Local employment and purchases and exports after all depend on whether the enterprise is operating or not and on what scale very much more than on who owns it.

It is valid to argue that injection of **new domestic equity or second tier capital** (e.g. subordinated, convertible, cumulative, payable when/if earned debentures) may allow a better deal for domestic parties. It is valid for a regulatory body to favour such a route. It is unlikely to be a prudent use of state funds except for large already state owned, or substantially owned enterprises and there because of the role as owner. E.g. the Philippine government is right to decline to contemplate investing in Philippine Airlines but - were it seen as key to restructuring National Power into several units for early partial placement and flotation at acceptable prices - might think it plausible to restructure its loans to National Power and/or inject new second tier subordinated convertible debt funding.

By the same token governments should limit extra incentives to foreign investors - especially ones not in practice available to domestic. Take or pay, dollar denominated utility contracts

are a glaring example. These place the entire growth projection and more than the entire currency risk on the state (unless the currency can plausibly be expected to appreciate against the dollar). 80% take or pay, 20% guaranteed available at 10% over base price, hard currency denominated payment for external debt (interest and principal) proportion of cost (base 80% only) and a domestic inflation minus - say - 2% formula for the remaining proportion of the price would be a much more equitable form and are carrying much less fiscal and forex risk to the state. Similarly proposals for the state to guarantee debt taken over or issued by incoming foreign investors should be rejected flatly and fully.

Monetary/credit policy in the reactive/crisis containment period faces four tasks, at least two partially conflicting:

1. a **low enough real interest rate** to avoid driving solvent, inherently viable enterprises into bankruptcy; increasing bank bad debt morasses leading to a generalised credit crunch and some otherwise needless bank failures and undermining/constraining fiscal policy;

2. a **high enough interest rate** to commend external credibility and avoid continued capital flight or leakage at levels sustainable only briefly;

3. **ensuring credit availability** - including to banks and financial institutions - is adequate to avoid deepening recession, unemployment and capacity underutilisation and to avoid bankrupting solvent and inherently (without a depression and with a recovery in - say - 2 years) enterprises;

4. **enforcing discipline** to underline the costs of imprudent lending/borrowing and to require balance sheet reconstruction.

While the last goal is better handled by prudential regulatory policy than by interest rates there is an inherent tension between the first two goals while failure in respect to either of them puts the third at risk.

Temporary suspension of external capital repayments reduces the forex demand and reduces the pressure on interest rates. Reconstruction - including debt profile lengthening and debt/equity swaps - does the same more sustainably. This is especially likely to be the case if lenders can be convinced - in the renegotiation context - that non rollover of credit lines and imposition of even short term interest rates over the 15%-20% range will increase bank bad

debts (and the number of bad banks) and reduce solvency of non-financial borrowers neither of which is in their interests.

Moral suasion has limits and should not be used to push banks (especially weak banks) into borrowing at high rates from foreign banks and relending at lower ones in domestic currency. True, their main customers are not the marginal loan recipients and can prudently be charged at nearer the (lower) average cost of lendable funds but - beyond making that point and suggesting more differentiation in rates based on better risk assessment - the safe role of moral suasion seems somewhat limited. (If a bank cartel is operating - a margin of much over 5% or over between Treasury Bill rates and prime enterprise borrower rates is *prima facie* evidence as is a similar gap between long term deposit and prime lending rates - there is a case for pressure but under competition legislation not crisis containing moral suasion.)

In **fiscal** as in monetary policy a crisis period tradeoff arises between increasing real and perceived external and financial sector robustness and limiting falls in fixed investment and employment and increases in poverty. The purpose of interim barrier erection between the domestic and global capital market is to **gain some room for manoeuvre**. How much is possible depends on:

1. pre crisis fiscal balance
2. sources of borrowing (and time profile of debt)
3. probability of inflationary impact of fiscal relaxation (interacting with devaluation, higher interest rates **and** a recession in domestic demand).

The likelihood that fiscal surpluses (probably even on recurrent account including interest) are unambiguously desirable is very low under the conditions posited - pace the IMF which has, grudgingly and slowly accepted that reality in East Asia even if its initial fiscal/monetary prescriptions for Thailand, Indonesia, Korea included ice packs as a cure for hypothermia (just as mediaeval surgeons prescribed leeches for anaemia). The question is what levels of public debt creation neither destroy investor (domestic and foreign) confidence, aggravate the domestic credit crunch nor kindle lasting double digit (especially over 15%) inflation.

The two main areas in which enhanced spending is likely to be needed are:

1. construction/civil engineering investment in infrastructure (including but not limited to labour intensive, employment - livelihood protecting quasi safety net programmes);

2. poverty reduction/livelihood shock alleviations measures to sustain access to basic food, health, education and water whether by lowering charges, subsidising poor household cash flows or interacting with infrastructure creation.

Given probable rises in unemployment and the specific patterns of demand likely to be sustained neither appears to be inherently inflationary. The **key macro demand fall** is in fact normally fixed investment (down one third in the defanged Tigers in 1998 versus at most a twentieth for domestic consumption) but the **leading social (socio economic) challenge** is likely to be livelihood/wage employment narrowing or degradation. Taken together these require a two focus package of spending, overlapping in the labour intensive small scale infrastructure area.

Clearly the greater the relatively soft, medium to long term external capital mobilisation possible the greater the degrees of fiscal freedom. For low income and perhaps lower middle provision of such finance for infrastructure and some poverty alleviation/reduction measures is a stated World Bank and Regional Development Bank priority. Pure safety net survival funding arguably should be external grant or domestic tax financed - its contribution to future fiscal revenue can be very real, but is neither direct nor all that convincing to financial institutions.

Successful **reactive/crisis containment** policy and praxis logically leads back to a new 'preventative' phase - 'preventative' because for some years (not necessarily as many as might be supposed) excessive - or even adequate/optimal - levels of inflow are not probable. However the monitoring transparency, reserving, provisioning - and reconstruction/liquidation of insolvent enterprises to avert a build-up creating problems later - operations should be kept in full force. A post crisis containment lethargy is only too likely

to allow new weaknesses and/or vulnerabilities to accumulate (e.g. Mexico 1996-97) and to provide the entry point for new shock wedges (in that case Asian crisis and petroleum price decline). Financial flow disasters are no more one off and non-repetitive than natural ones such as droughts and floods. International coordination of monitoring, information presentation and standard setting combined with (literally) standby loans/lines of credit for proactive crisis avoidance can reduce the frequency, the depth and - hopefully especially - the contagion epidemic effects of financial flow reversal. They cannot eliminate them.

ANNEX A

HIPC/HIBS/HIRAS - Avalanche Overhang

The current **financial flow reversal crisis** has tended to push the **Highly Indebted Poor Country** debt writedown initiative out of focused attention. That is inevitable - the crisis threatens the global financial system and could lead to a global recession, HIPC's are neither large enough nor globally involved enough to do either. Even they would not benefit if negotiating debt writedown for Tanzania and the programme's extension to Nigeria were carried on at the expense of halting the dodgem car knock on collisions that began in July 1997 when the baht crashed and burnt in Bangkok.

Basically the HIPC process is complementary to, or even a precondition for, the preventative proposals. If present debt service met is crushing or large amounts of arrears have piled/are piling up in semi condoned, *de facto* default, then prudent medium term planning - by states or enterprises - is not practicable and the overhang reduces confidence. If now paid, it would be unsustainable; if now suspended but not written off, its future reactivation could crush currently sustainable balance of payments patterns. In the second case provisioning and reserving by raising foreign asset holdings could be feared to make claims for renewed debt service more likely.

However, the multiple fragilities re-exposed over 1997-200? Suggest HIPC needs to be deepened (remaining debt service is too high for robustness in the face of climatic, relative price or macroeconomics environmental shocks), widened (by open ended entry provisions for countries now not eligible because they have or until recently have had no functioning governments, not because they are not poor and highly indebted), speeded up (at least by freezing payments due to be written down during the 6 years to eligibility period and probably shortening that period) and structurally adjusted for post conflict or collapse economies (e.g. to ask for macro structural soundness of policy for six years from Congo ex Zaire, Somaliland, Rwanda and - presently - Sudan before HIPC writedowns is to create a Catch 22 situation and to present the early support necessary - even if not sufficient - for rehabilitation and reconciliation to have a chance). HIPC needs to be more robust because the global economic climate is stormier than previously perceived but in ways that were largely already identifiable. Similarly border line cases such as Nigeria (both as to how poor ad whether its 93-98 period is analogous to civil war or total state disintegration) might also

usefully be considered for inclusion. (The 6 year role on entry into force of HIPC is mordantly amusing given the IMF objection to the Clinton pre crisis standready financial package in place proposals unless all such facilities lapse in 12 to 24 months **because** country policies change so markedly and rapidly.)

Broader debt reduction in the context of short term financial tsunami is an issue much more integrally related to global investment flow issues. It is a different issue because the countries involved are primarily - in terms of GDP, trade and financial flows - lower middle or even middle income; the debts involved are primarily mixed non financial enterprise and financial enterprise not sovereign and the initial time profile of the bulk of the debt at risk ranges from on demand to 18 months. That means more actors in any renegotiation and broader/more complicated writedown/restructurings. Further, if restructuring takes place prudently and promptly enough to avert a full blown crisis general writedowns are not necessarily a central issue:

1. for the bulk of the borrowings guaranteed 90% rollover for 24 months and/or restructuring half of 0-365 day, debt to 365-1800 day with rollover on the other 50%, may very well be adequate to overcome what is in ouch cases an illiquidity rather than an insolvency problem. That type of restructuring involves no real loss to the lenders unless the new rates are lower - indeed by avoiding disorderly default and devaluation it saves them money;

2. for some enterprises the issue is indeed can't pay or at least can't pay in full not just need more time to pay, because the enterprise for whatever reason is insolvent as well as illiquid. Alternatively it can be solvent only with a 1 to 3 year (lower) interest payment only period to adjust to terms of trade (on visibles and/or on debt service) shocks inducting devaluation. In these cases the most practicable form of debt writedown and the one most consistent with debtor/creditor cooperation to maximise value for each available five to ten years down the road is likely to be converting portions of short and medium/long term debt to either equity or "tier two" subordinated, convertible, cumulative, subordinated debentures or income notes (or into equity which is simpler but not necessarily tax or confidence risk efficient for either lenders or debtors) while restructuring short term project finance duration to fit project cash flow and creating more stable working capital access. As the types and degrees of alternation will vary widely

with the initial structure, the post shock viability of the borrower and the time frame for recovery HIPC type macro generalisations cannot be applied to individual cases.

In this type of renegotiation/restructuring of non-sovereign debt it is perverse to speak of the government as being "in default" even if it chooses to use a 90 day suspension of principal payments to create a context conducive to more orderly negotiation. No one has seriously asserted South Korea was in default when it called for and to a large extent secured such a process with the implicit warning of a suspension had the creditors not responded. To assume that - with the Rupiah then at R15,000 = $1 and plunging - Indonesian non suspension would have meant continued non-sovereign debt service is preposterous. Only a handful of export focused companies or substantial external asset holders could possibly have done so for more than a few weeks. For a state to assert that to minimise loss to debtors **and** creditors an orderly **renegotiation among creditors and debtors mediated by the state** (and perhaps an international financial entity) and perhaps backed by an interim suspension of principal repayment is necessary is neither nonsense, confiscation nor *per se* anti market or anti creditor. The present problem is **in general** the lack of agreed guidelines as to when such a suspension can be justified (and who can "validate" it albeit the only present practicable answer is clearly the IMF) and what the processual and time parameters for restructuring should and **in specific** the confiscatory, anti external debtor, unlevel internal playing field non negotiated enforcement of non-sovereign (as well as partial sovereign) default by Russia.

But HIPC's and even HIPME's (Highly Illiquid Poor Middle Economies) are only one aspect of problems which - unless addressed now - will hamper or prevent Preventative and Proactive action to avert (or at least reduce and control) the next external short term financial flow crisis. Two others are:

1. HIBS (Highly Insolvent Banking Systems); and

2. HIRAS (Highly Inadequate Regulatory and Audit Systems).

At present the banking systems of Thailand, South Korea and Indonesia are massively insolvent while those of Malaysia and, to a lesser extent, the Philippines are at risk. While restructuring is in progress in Thailand and South Korea the cost on direct data and the Mexican "tequila! Analogue suggest 15% of GDP will be needed to re-establish credible balance sheets and the confidence to lend prudently (as opposed to ultra conservatively and

very little or recklessly and massively in hope something - other than size and depth of holes - will turn up). The situation in many poor countries (including a majority of HIPC's_ is just as bad; only a minority have (with World Bank sectoral lending and Treasury security injections) carried out even moderately convincing banking sector restructuring.

Reconstruction is needed quite apart from the short term external financial flows issues. An insolvent banking system (or indeed are in danger of tipping to insolvency) can only continue to provide credit even to good enterprises as long as its insolvency remains unknown to its depositors and creditors (who will learn soon after its manager and regulators because of leaks to "cronies") or so long as it uses very limited external finance and its domestic creditors are reassured by a credible, open ended government guarantee to inject finance and liquidity (presumably by providing government paper to fill balance sheet holes and proceeds of government paper sold to others to bolster liquidity). That is hardly a prudent (as it encourages continued imprudent and/or unanalysed lending) or a sustainable (given the likely escalation of the burden on the Treasury and its limited access to non-bank lenders) position.

In most of these cases three external inputs are needed:

1. advice on and personnel to take part in restructuring to support whatever domestic body is responsible;
2. finance to complement domestic resources in recapitalisation and meaningful deposit insurance system creation;
3. enterprise (i.e. foreign bank) involvement whether by new entry, expansion, strategic stake holding or take-over to augment limited (even after reconstruction) domestic personnel and financial capabilities, to broaden the range of services - especially international market oriented ones - and to provide competition and standards for judgement in what have, at best, been sleepy, protected markets (including for long established foreign banks).

A scorched earth policy - instant liberalisation and new foreign bank conquest of the market - is rarely feasible. The depositors of the failed domestic (and often old foreign) banks would still need to be compensated. Creating retail branch banking in low and lower middle income countries is not seen (perhaps wrongly) as attractive by most internationally expansive banks (South African are exceptions, Malaysian were and HSBC under certain circumstances might

be). Many viable domestic enterprises would be at severe risk of failing before they could establish working capital finance relations with the new banks. With no serious regulatory system (especially for externally based banks) in place the countries would be at grave risk of plundering by new BCCI's and lesser operators of that ilk.

The reasons for requiring **external information and supporting personnel** are obvious. Those for **capital to reconstruct/set up deposit insurance** may be less so. These are basically domestic currency costs, and to the extent reconstruction is successful, they can be met by issuing medium to long term government securities. That issue would not *per se* be inflationary because filled balance sheet holes do not necessarily lead to more lending let alone more propensity for depositors to pull their money to stuff mattresses or to increase consumption. To a degree the same holds for initial period underwriting/guaranteeing of deposit insurance. Presumptively if payouts are needed they will in large part be redeposited not spent and if deposits plus backing are transferred to sound banks they can hold the medium/long term paper.

However, two factors qualify the premise of suitability for domestic finance very substantially. First reconstruction cost is likely to be 15% of GDP (e.g. Mexico 1995, estimated Korea 1998 assuming ultimate recovery of 50% of problem loans, Thailand 1998, Malaysia 200?). That type of leap in sovereign borrowing/GDP ratios does have an impact on markets even if the short term impact on domestic demand is negligible. Second the purpose of reconstruction is to enable commercial banks to return to playing their role in a market economy - providing working capital and financial services to viable enterprises. Therefore, a portion of the recapitalisation will (and should) need to be liquid to promote real economy as well as bank security recovery. In a depressed economy such increases in lending to productive enterprises may not be particularly inflationary, but state borrowing (whether domestic or external) from non bank sources to finance them is likely to run into monetary, fiscal and credit market constraints.

The **main source and mobiliser** of financial sector reconstruction loans and main advisor on sectoral reconstruction has to date been the **World Bank**. This is not as surprising as it may seem at first glance. Financial institution reconstruction and regulation is in implementation dominantly, and in design substantially, micro/sectoral which is the Bank's side of the smudged line in the sand division of labour with the IMF. As a result of this history the Bank has more experience and expertise on how to rebuild institutionally and in detail and how to

finance than does the Fund. More macro coordination with the Fund - and more use by the Fund of SAF/ESAF for financial section reconstruction rather than as a smaller less efficiently targeted or monitored IDA - is desirable, but there is no reason the Bank should not be involved in institutional recapitalisation, relaunching and regulation simply because the enterprises in question are banks not factories or ports.

HIRAS - highly inadequate regulatory and audit systems - have **not received very much articulated "how to" attention at country level** despite the fact that at an optimistic estimate 150-175 of the 200 odd global territorial entities (including the wilful HIRAS of such offshore havens as e.g. Cayman, Surinam, Turks and Caicos, Jersey, Guernsey and - one must fear - the offshore platforms appended to distinctly **non** HIRA domestic financial markets such as Hong Kong, Singapore, Ireland, which have not had transparency and disclosure rules adequate for national regulators to know what scorpions are hidden under rocky banks and rotting hedge funds) **are** HIRAS.

So long as a country is a **HIRAS** with the best regulatory and policy will in the world, and with otherwise well designed enterprise friendly, social cohesion positive strategy and practice, its government is very likely to find itself unexpectedly confronting a **HIBS**. Certainly it cannot operate any of the preventative, proactive and reactive policy packages proposed in the main text since it will back data let alone legal or practical enforcement powers.

Turning HIRAS into ARAS (Adequately Regulated and Audited Systems) is time and personnel consuming and a multi (3 to 5 minimum) year process. It is unlikely to be possible for most countries individually (or to be particularly effective regionally or globally) without both coordination as to standards and mobilisation of data and personnel to **assist** - and to **monitor** - national processes. A possible set of coordinating for a would be the regional development banks regionally and the World Bank globally. However, each would need to coordinate with national regulators (and their international for a) to secure both "best practice" guidelines and a pool of experienced personnel for secondment and monitoring operations.

Some of the aspects of ARAS particularly relevant to recording, monitoring, reporting and managing international capital flows (especially short term enterprise sector ones) have been

addressed in the main text. A complete approach would require a textbook not a part of an Annex.

However the need for **agreed best practice and possible accepted variants** on it can be illustrated by treatment of "problem" loans. Treatment in regulatory systems of some substance ranges from 30 days overdue on principal **or** interest **or** within three years of restructuring to 90 days overdue on principal **and** interest (and with no recent restructuring provision).

The first may be too conservative - especially in systems which have had recent reconstructions and recapitalisations with a substantial proportion of loans being and likely to continue to be serviced but reconstructed. The latter can be dangerously lax (especially when substituted for a tigher definition in a context of rising "problem" loans and moral suasion to continue lending to weak borrowers and to roll forward their principal repayment schedules - as in Malaysia). But it may well be a range of choices is acceptable so long as there is full disclosure both of the definition used of what the figure would be on major alternative definitions. Similarly the complexity of regulations/regulatory processes and the use of banks as proxies (e.g. to enforce leverage limitations on non bank financial and non financial enterprises who borrow from them) may well need to be articulated differently by region and by the degree of development of the national financial system. Again there is still a need for transparent explanation of the regulations and procedures and of their differences from Northwestern best practice (assuming a certain consistency of best practice rules among the USA, Canada and main EU members hopefully extending in the future to Japan).

ANNEX B

FINANCIAL FOLLY, GENERALISED OVERCAPACITY, CONSPICUOUS SAVING OR MOSAIC?

One interpretation of the 1995-200? Economic crisis is in terms of **generalised overcapacity** whether pursuing the Hayekian business cycle model or its origin in (ironically) Marx's unfinished draft of **Das Kapital** - Volume III. The Marxian model turns on a rising ratio of savings to (subsistence level and numbers constrained) consumption interacting with higher productivity (raising output at any given number of workers and, therefore, of consumption) and with higher fixed to circulating capital ratios (inevitable if output per worker rises and wages do not) which lowers the rate of surplus value extraction on total capital. Hayek - like any other economist not following a rigid subsistence wage thesis and/or allowing amenity and conspicuous consumption by capitalists - has a less inevitable juggernaut, driven by rising savings by enterprises and individuals outstripping the growth of consumption and therefore generating overcapacity initially in final goods but reacting back for greater final revealed overcapacity in investment goods.

This pair of models were until recently viewed as curiosities. Inventory cycles, wave effect overcapacity in specific industries, declining sector overcapacity ere taken seriously as was generalised national overcapacity resulting from bad macro policy leading to unsustainable external imbalance and rigid production structures were taken seriously. The Marx-Hayek models were not beyond limited for left and for right true believers.

But from 19975 there has been a revival in overcapacity based argumentation citing South Africa, automobiles, South Korea, steel, Malaysia, IT chips, Japan, property, China etc. The argument is not simply that in decline capacity is underutilised because of the decline but that **general overinvestment has led to unutiliseable capacity and thus caused the decline**. In this perspective the **financial flow crisis is a secondary/consequential effect** a rising from the late realisation that much investment was inherently non viable.

Is this a valid general perspective? There are sunset or at least post noon industries like steel with new arguably competitive entrants exceeding downward rationalisation. There are easy entry/high demand growth/rapid technological change industries like pc's and chips in which prices and demand for some lines have plummeted while capacity exploded. In cases like

automobiles large new entries seeking scale while existing units sought consolidate and raise productivity with few, if any, capacity cuts have led to global overcapacity. There are - as there have always been - property booms. More generally concern for market share and output expansion nominally (but possibly neither realistically nor convincingly) justified by long term profitability/survival have led to capacity expansion a shorter time focus, higher discount rate, more cautious market expansion analysis strategy would not have undertaken. But **is there generalised overcapacities globally or in most peripheral economies?**

On balance no. The USA and EU have pockets of overcapacity in subsiding areas (e.g. Appalachia, Wallonia) and industries (e.g. steel) and problematic areas in which the fight for survival/market share has, at least for the present, interacted with new entrants to create overcapacity (e.g. pc's, chips). But over 1995-1998 these economies have not been held back by excess capacity/stagnant domestic demand. Nor until the 1997 crisis was Asia characterised by stagnant domestic demand - *au contraire*. Apart from chips and automobiles serious inherent overcapacity was evident only in South Korea and Japan albeit Thailand, Malaysia and perhaps Indonesia, Hong Kong and Singapore arguably constituted additional overinvestment cases. Certainly the Russian, Venezuelan, Ecuadorian, Mexican and Brazilian cases of 1998 do not look much like the Hayek-Marx model. Nor does South Africa whose capacity problem focuses under the (broadly defined) national economic defence industries built up under apartheid in a context of growing global economic closing (to and by SA) and now increasing economic opening.

However, a characteristic of several economies now in crisis or depression - South Korea, Hong Kong, Japan, China, Malaysia, Thailand, Singapore, Indonesia - has been **savings rates of 30% to over 50% of GDP**. Combined with easy access to foreign finance and a high (self justifying as long as investment remains high) growth of capacity, output **and** domestic (as well as export demand) these savings levels did lead to what Alan Greenspan describes as **"overexuberance" not just in commercial and residential buildings and financial instruments but also in power plants, factories and toll roads. Savings and their investment had arguably become the 'New Conspicuous Consumption' to mutate Veblen**. But this pattern was neither global nor tied umbilically either to foreign funds inflow nor to boom - wide post bubble Japan where the prudential savings level and market share/power investment levels have indeed impeded recovery based on or substantially

sustained by domestic demand. There may be elements of Marx/Hayek but only in a very general sense.

1995 (dating back to the Tequila crisis which in retrospect seems the first stage of the more contagious Defanging of the Tigers crisis/catalyst) onward appears a **mosaic with certain general characteristics and certain contextual specificities linked and catalysed by financial flows unprecedented (in and out) as to volume, global reach and volatility**. Direct private investment while concentrated in a handful of countries did begin to globalise - $2,500 million in two projects (aluminium smelter and natural gas production/pipeline) in Mozambique and about $500 million in gold mines build-up (toward 600,000 oz. a year before 2005) in Tanzania may be trivial globally but in each case the investment exceed GDP (by several fold for Mozambique). Footloose financial capital globalised even more dramatically. When - as was true for several years in the mid 1990's Kenya, Uganda and Tanzania have net sales to external buyers of local currency denominated short term government paper clearly access - at a price - is more open in kind, not just degree, than in the 1980's or 1970's let alone the 1960's or 1950's.

1. **very high savings rates** in some countries which together with easy access to foreign exchange led to inherently unsustainable property, power, transport and manufacturing investment together with **currency overvaluation** increasingly **hampering both export growth and holding domestic market share** (especially in a context of liberalisation);

2. **increasing fragility of many financial systems** partly caused by and partly causing reduced care in risk evaluation and frenetic expansion/diversification/intermediation to raise profits and trade out of trouble (at least in intent);

3. **liberalisation of trade and financial markets, on a scale and at a pace with which many protected produced economies with rigidities were ill suited to cope** and in which most recipients **and** suppliers of finance acted with remarkably little sombre risk analysis or attempts to understand history to avoid repeating it;

4. a degree of **long termism** (including permanent expansion), **turnover** and **market share** focus which has eroded attention to **prudent cash flow, leveraging limit and profitability projections** and to **risk from external shocks and/or halts to growth**. The same weakness has appeared on the social side. Increased employment - at least in Asia from 1950's Japan through 1990's Indonesia - has been so sustained and so effective at

reducing poverty levels that few Asian countries (Singapore and - to a less degree - Japan are partial exceptions) have even minimal national social safety nets. At best this leads to focus on pain sharing (Thai preference for severe way cuts and modest redundancies which may be socially less corrosive but may or may not be enterprise cost/productivity effective) and at worst to explosive tensions (e.g. in somewhat different ways Indonesia and Malaysia) because job loss drags down both directly hit and extended families into the poverty abyss they believed they had escaped - and the government claimed credit and earned legitimacy for facilitating/causing that escape. As the World Bank is still discovering a crisis may heighten the need for a basic safety net but is not the most propitious setting for seeking to establish one.

5. **a decade of drag** from the world's second largest economy (**Japan**) whose export surplus became as much a result of domestic demand stagnation as of competitiveness and whose high savings rate contributed both to **domestic demand deliquescence** and to **plugging the gaps its external current account surplus created** by purchasing securities (especially $ ones) and investing (shifting additional production abroad) directly in **external production** facilities.

These elements - plus such narrower factors as Brazil's chronically high state borrowing requirement and the 'godfather' economy in Russia - for a time sustained each other and rapid growth in world trade and output in much of the periphery and some parts of the OECD core. But over time the cracks and contradictions become more apparent and confidence more brittle. The Tequila crisis raised a few doubts and led to no significant systemic reform; the Tiger crisis put confidence on a knife edge; the Russian economic house of cards' collapse set off a near lemming flight to quality, exacerbated by/as well as leading to the LTCM near collapse.

The partial distraction of attention in the USA is a contributory non-economic factor. However, Messrs Clinton, Robin and Greenspan appear to be directing high quality and coherence analysis to the global economic trajectory and doing more to increase the chances of averting meltdown than any other country or institution so placing a heavy emphasis on Monicagate may be misleading. Indeed it is arguable that only the totemic faith of US individuals and institutions in Greenspan and therefore in his action to bail out those who would have been massively hit by the disorderly unwinding of LTCM (and in its whirlpool other 'hedge' funds) and following up by two (even if small) interest rate cuts has averted a

Kredit Anstalt collapse and financial system meltdown rerun. To date his mirror image Joshua trumpeting 'They shall not fall' outside the New York Financial citadel (with some zither accompaniment by Brown and Blair) has worked well (whatever one thinks of its logic) but assuming it does lead to a 'new promised land' of restored global financial stability an institutional and systemic replacement is needed - convincing prophets to counteract financial fear cannot be produced on call.

In the end while the tendencies to **overinvestment** (and oversaving) in some countries is a contributory factor and a **real economy/financial system bridge** the **basic link both in the upswing and now does appear to be international financial flows**. The psychology (parallel exuberant entry followed by parallel terrified attempted exit) has been familiar enough for 150 years or more since the first waves of investment in post colonial Latin America, Canada, the USA, Australia, Central Europe, and (somewhat later) South Africa. One may be tempted to cite John Law, tulips and the South Sens (or for LCTM the Company with the highly profitable objective but not to be disclosed) but that is somewhat misleading - except perhaps for Russia and LTCM - as those were Ponzi schemes or pure rip-offs. This has not characterised most 1990's lending. Whatever else can be said of them loans to Korean chaebol and even Indonesian 'First Family enterprises' and Pergau Dam did go to construct capital assets which did produce and were (however over-exuberantly) also expected to produce profits and cash flows to service/repay debt.. The differences are globalisation (coverage as to country and as to enterprise sector), quantity (absolutely and relative to international trade and, eve more, production), obscurity (with numbers of new actors and new instruments outstripping increased data flow) and unexamined liberalisation (tearing down administrative intervention before designing transparency and prudential regulation substitutes let alone putting them in place).

Ref: RHG/lab/pprrsgj.doc 23.10.98