Responding to 21st Century Financial Crisis

During the 1990s, financial crises appear to be almost annual events. Examples abound: the collapse of S & Ls in the United States in 1989-91; currency mayhem in Europe during 1992-93; Mexican devaluation and banking crisis in 1994-95; Japanese banks teetering on the verge of default in 1995; currency collapse and bank failure throughout East Asia in 1997-98. Something new and dangerous appears to be afoot -- something Michael Camdessus (Managing Director of the International Monetary Fund) has called a '21st Century Financial Crisis'.

How should the international community respond? This case presents the views of two engaged observers: Joseph Stiglitz, the Chief Economist of the World Bank, and George Soros, hedge fund manager and self-styled international philanthropist.

BOATS, PLANES AND CAPITAL FLOWS

As capital shifts rapidly across the globe, emerging markets are left adrift. The answer is to regulate flows ...

by Joseph E. Stiglitz, Chief Economist of the World Bank.[1]

> Small open economies are like rowing boats on an open sea. One cannot predict when they might capsize; bad steering increases the chances of disaster and a leaky boat makes it inevitable. But their chances of being broadsided by a wave are significant no matter how well they are steered and no matter how seaworthy they are.
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> The financial movements of the past few years are like the sea. Net long-term private capital flows to developing countries rose sixfold from 1990 to a record $256bn (£153bn) in 1997, according to the Global Development Finance 1998 report by the World Bank released today. These include foreign direct investment, investment in equity and credits of over a year's maturity. The stock of short-term debt by countries in mid-1997 was $360.9bn.

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[1] This is the text of an article that appeared in the *Financial Times* on Wednesday March 25, 1998. Reprinted with permission.

Prof. Huw Pill prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

All developing countries are afloat on this sea. Bond issues and loan commitments to east Asia, south Asia and Latin America all fell by more than half in the fourth quarter of 1997. This illustrates that developing countries are more vulnerable to vacillations in international flows than ever before. Without volatile international capital flows, the East Asian crisis of 1997 would probably have been no more memorable than the South Korean crisis of 1980 or the Thai one of 1983.

Everyone recognises that this is not the best of all possible worlds. What can we do about it?

Part of the answer is easy: insist on more information and greater disclosure. Both the Mexican and the east Asian crises were triggered and exacerbated partly when investors found out that reserves were smaller than they had thought and that short-term debt was higher. Perhaps more important than misleading information was the general lack of it: when the problems became apparent, this made it hard for lenders to distinguish bad companies from good, leading them to shy away from all.

The returns to better information are great, but we should not delude ourselves into thinking that this alone can resolve all the problems.[2] Much existing information seems not to be fully incorporated into market assessments, so there is no guarantee that markets will respond perfectly to perfect information. In a world dominated by private-to-private capital flows, it will be very difficult to estimate the external exposure of an entire economy. And with the increased use of derivatives, it will be virtually impossible. Better information is like a better navigation chart: useful, but not everything.

For emerging markets, another part of the answer is also easy: domestic reforms can create more robust financial markets, more transparent systems of corporate governance, and less error-prone macroeconomic policy. But as with better information, so with better policies. It would be foolhardy to base domestic regimes and the international financial architecture on the assumption that these will be perfect. Developing countries have less capacity for financial regulation and greater vulnerability to shocks. Policy regimes need to be resilient against human fallibility. Aircraft are not designed to be flown just by ace pilots.

So we - investors, emerging markets and the international financial community generally - need to consider a third policy response: towards international capital flows. We cannot expect it to eliminate all crises, let alone all economic fluctuations. But along with domestic reforms and greater disclosure, it will reduce their frequency and magnitude.

Some people object to this in principle, arguing that governments should not intervene in international capital markets. This objection is not a good way to begin the discussion. The $110bn package for east Asia is clearly a major intervention in the workings of the free market.

Intervention has been justified on the basis of systemic risk, which is the classic case of what economists call an externality. Externalities can occur when the private risk of investing in a country is smaller than the social risk. This discrepancy may be especially

[2] *Casewriter's footnote:* Following the Mexican crisis of 1994-95, the G-7 group of industrial countries (meeting at Halifax, Nova Scotia) proposed new rules for prompt and accurate disclosure of economic statistics. In response to these Halifax proposals, the IMF imposed 'disclosure requirements' for statistics such as international reserves, balance of payments data and international borrowing. Countries were divided into groups, with more onerous requirements imposed on those wishing to access the international capital market. The IMF monitored compliance with the new rules and published regular lists of those nations that satisfied the requirements.

large for short-term speculative capital flows. Whenever there are large discrepancies of this kind (and they would exist if investors believed a bailout were likely even if systemic risk did not exist), then some form of intervention would be justified to bring the private risks into line with the social risk. But what kind of intervention?

There is now broad agreement that foreign direct investment is valuable. It brings not just capital but also technology and training. Preliminary evidence from east Asia confirms that foreign direct investment is relatively stable. Short-term capital does not bring with it ancillary benefits. True, some short-term capital, especially trade credits, is essential. But when the savings rate is already high, and when the marginal investment is being misallocated, additional short-term capital flows just increase the vulnerability of an economy. The net benefits appear even smaller when the reserves set aside to protect against the volatility of short-term capital are taken into account. From the consolidated balance sheet of the borrowing country, it seems as if emerging economies are borrowing from developed countries at higher rates, only to relend a large fraction back in the form of treasury bills and other low-rate-of-return instruments. The economic slowdown resulting from the crisis in east Asia may more than wipe out the gains from the recent capital inflows.

To extend the airplane metaphor that has been used in this discussion, what is at stake is not just a dramatic aircraft crash, an occurrence so rare that almost no one would question the superiority of air travel, especially for long distances, nor the role of government in enhancing safety. But the record of small planes traveling short distances is in greater doubt. So what would a new regime for short-term capital flows involve? There are many components.

First, we need to eliminate the tax, regulatory and policy distortions that may have stimulated such flows. Examples of distortions are evident in the case of Thailand where the Bangkok International Banking Facilities (BIBF) in effect encouraged short-term external borrowing.[3] Subtle examples exist almost everywhere.

Second, several countries have imposed prudential bank regulations to limit the currency exposure of their institutions. But these measures may not go far enough, because they do not address the issue of corporate exposure. Among the ideas under discussion are inhibitions on capital inflows, especially of the Chilean type. Chile has imposed a reserve requirement on all short-term capital inflows - essentially a tax on short-maturity loans.[4] Even critics of the Chilean system acknowledge that the reserve requirement has significantly lengthened the maturity composition of capital inflows to Chile. This, together with solid fundamentals and a sound financial system, may be the reason that Chile has been relatively unaffected by recent financial crises.

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3 *Casewriter's note:* The BIBF was an attempt by the Thai authorities to prevent their financial services industry from migrating offshore to international centers in Hong King and Singapore. The government structured the tax and regulation rules in a manner that discriminated in favor of Thai banks borrowing from abroad and in foreign currency. For example, foreign currency denominated deposits were exempted from some reserve requirements.

4 *Casewriter's note:* The details of the Chilean system are extremely complex and have varied through time. However, the essentials are as follows. For every tranche of short-term capital that enters Chile, a certain proportion has to be lodged in an interest free account at the central bank. Since the interest foregone on this tranche reduces the overall return on the investment, this is equivalent to the imposition of a tax that deters inflows. Since the magnitude of the reserve requirement decreases with the maturity of the capital inflow, the Chilean authorities have created incentives to lengthen the maturity structure of Chile's external liabilities. Inflows of less than one year maturity faced a penal reserve requirement of 30%.

Still other possibilities that may be more feasible for others include the use of tax policy by, for example, limiting the extent of tax deductibility for interest in debt denominated or linked to foreign currencies. Other issues have to be addressed at the international level. In spite of repeated resolutions that lenders should bear more of the cost of their risky decisions, the moral hazard problem in the 1990s is, if anything, larger, not smaller than it was in the 1980s. At the same time, workers and small businesses in borrowing countries - innocent bystanders who did not engage in risky transactions - continue to bear huge costs. Now is the time, before the next crisis, to devise orderly procedures for work-outs that will provide better incentives and more equitable cost-sharing. The financial architecture for nation states took centuries to build; today, concepts like national banking are still controversial in parts of the US. Arriving at a consensus about international reforms could be even more difficult. But the intensified international dialogue on these issues, at the very least, is a promising start.

AVOIDING A BREAKDOWN

Asia's crisis demands a rethink of international regulation ...

by George Soros, Chairman of Soros Fund Management and of the Open Society Institute.[5]

The international financial system is suffering a systemic breakdown, but we are unwilling to acknowledge it. The abandonment of fixed exchange rate regimes in south-east Asia touched off an unraveling process that has exceeded everyone's worst fears, including my own. So far the large bail-out programmes implemented by the International Monetary Fund have not worked.

Lending by the international financial institutions can never replace lending by the private sector. The rescue packages are supposed to do their work by re-establishing private sector confidence. Unfortunately, the currencies of the debtor countries have continued to depreciate, aggravating their debt problems and further undermining confidence.

The countries concerned were over-indebted to start with. The decline in their currencies, coupled with the drastic rise in interest rates, has rendered the debt burden even more crushing.

We are dealing with a self-reinforcing process. Once it is reversed, it could become self-reinforcing in the opposite direction. The trouble is that the process is still moving away from equilibrium. It is impossible to tell how far it may go. What started out as a minor imbalance has become a much bigger one that threatens to engulf not only international credit but also international trade. We are on the verge of worldwide deflation.

The IMF has been criticised for applying the wrong remedy. The FT's columnist Martin Wolf has pointed out that the deflationary effect of the debt burden is reinforced by the deflationary effect of the IMF programmes.

Jeffrey Sachs, director of the Harvard Institute for International Development, has carried the criticism further by blaming the IMF for insisting on punitively high interest rates. But high interest rates are essential to prevent the currency from going into a free fall. They have served to protect the exchange rate in countries as diverse as Hong Kong and

5 This is the text of an article that appeared in the *Financial Times* on Wednesday December 31, 1997. Reprinted with permission.

Russia. It is difficult to see how high interest rates could be avoided, given the constraints under which the IMF operates.

The problems run much deeper. But we are unwilling to face them. The prevailing system of international lending is fundamentally flawed, yet the IMF regards it as its mission to preserve the system. This does not imply I am not a great believer in the IMF. Without it, and without other official creditors, the system would already have collapsed in 1982 and again in 1994-95. With luck, we may pull through once again. But it is high time to recognise the defects of the system and reconsider the mission of the fund.

The private sector is ill-suited to allocate international credit. It provides either too little or too much. It does not have the information with which to form a balanced judgment. Moreover, it is not concerned with maintaining macro-economic balance in the borrowing countries. Its goals are to maximise profit and minimise risk. This makes it move in a herd-like fashion in both directions.

The excess always begins with overexpansion, and the correction is always associated with pain. But with the intervention of the IMF and other official lenders, the pain is felt more by the borrowers than by the creditors. That is why overexpansion has recurred so soon after each crisis. Successive crises have, however, become more difficult to handle.

In 1982, banks lending to Latin America were involved for their own account. The crisis was contained by persuading them to act collectively and to extend fresh credit to allow the debtors to service their debt. The banks did get hurt in the process although not as much as the borrowers. Latin America lost a decade of growth. The banks learned to minimise their own exposure and to act as underwriters and wholesalers instead.

In the 1994-95 crisis, it was the holders of Mexican treasury bills that had to be bailed out, mainly by the US Treasury. By 1997 some of the banks had forgotten their painful experiences and became engaged on their own account, particularly with South Korean companies.

The Korean crisis, as distinct from that in other south-east Asian countries, bears some similarities to Brazil in 1982 - with one major difference: the loans are not to Korea as a sovereign country but to individual companies. This has made it more difficult to get the banks to act collectively.

Since we are in the middle of a crisis it is impossible to predict how it will play itself out. There are other shoes that may yet drop, notably China. On the other hand, Japan, which looks so bad at present, has the wherewithal to solve its problems.

It is not too soon to start thinking how the system could be improved. Fresh ideas on the subject could even have a beneficial effect on how the current crisis is handled. But that would require questioning some of the most cherished tenets of the business community. To argue that financial markets in general, and international lending in particular, need to be regulated is likely to outrage the financial community. Yet the evidence for just that is overwhelming.

Given the uneven distribution of savings and investment opportunities, there is a crying need for international capital movements. But the private sector is notoriously inefficient in the international allocation of credit. It follows that international capital movements need to be supervised and the allocation of credit regulated by an international authority.

This goes against the grain of prevailing wisdom. How can bureaucrats know better than those who take risks for their own account? The answer is that the technocrats running the proposed international authority would be charged with maintaining macroeconomic balance, while the technocrats in charge of banks are guided by profit considerations. Banks earn fees as well as a return on capital and in the end they can count on the support of the official lenders, because IMF and central bank intervention - like that in Korea - tends to favour creditors. It would be better for the official lenders to control the risks they are taking more directly.

I propose setting up an International Credit Insurance Corporation as a sister institution to the IMF. This new authority would guarantee international loans for a modest fee. The borrowing countries would be obliged to provide data on all borrowings, public or private, insured or not. This would enable the authority to set a ceiling on the amounts it is willing to insure. Up to those amounts the countries concerned would be able to access international capital markets at prime rates. Beyond these, the creditors would have to beware.

The authority would base its judgment not only on the amount of credit outstanding, but also on the macroeconomic conditions in the countries concerned. This would render any excessive credit expansion unlikely. The capital of the proposed institution would consist of Special Drawing Rights (SDRs).[6] This would render its guarantees watertight. The SDRs would not be inflationary because they would be used only in case of default; at that time they would replace money that had been lost.

There are many issues to be resolved. The most important is the link between the borrowing countries and the borrowers within those countries. Special care must be taken not to give governments discretionary power over the allocation of credit because that could foster corrupt dictatorships. But once the need for such an institution is recognised, the details could be worked out.

The institution can be set up only at a time when international lending is in a state of collapse. We are now entering such a period. We can probably navigate through it without setting up a new international authority of the sort I am proposing. But we would be missing a great opportunity.

Moreover, the extent of the crisis could be mitigated by the prospect of an early revival of international lending on a sounder footing. If the world is indeed entering a deflationary period, an International Credit Insurance Corporation could play an important role in containing its negative effects.

6 *Casewriter's note:* SDRs are currency units created by the IMF to provide international liquidity. Their value is determined by pegging to a basket of convertible international currencies, such as the dollar, yen and Deutsch Mark.