Distr.
RESTRICTED

LC/R.1841
3 September 1998

ENGLISH
ORIGINAL: SPANISH

E C L A C

Economic Commission for Latin America and the Caribbean

HANDLING AND PREVENTING FINANCIAL CRISES*

* Document not subjected to editorial revision.

98-9-678

Table of Content

Page

Abstract v

INTRODUCTION 1

1. The volatility of the present international financial system 1
2. Time for wise decisions that will benefit all concerned 2
3. A proposal for stable and sustainable financial development 3

   a. National financial arrangements 3
   b. International financial arrangements 4

Abstract

Opening up the capital account can bring great benefits to the world economy. However, it can also entail significant costs.

In fact, finance has been at the heart of international economic crises. The financial dimension played a key role in the 1930s depression and the debt crisis of the 1970s. In the present decade, finance has been a key factor in both the Mexican and the current Asian crises.

The recent crises have turned the spotlight on the imperfections of the international capital market and the great vulnerability of developing countries to international financial shocks. The first of these problems is reflected in the volatility that has characterized the capital market in recent decades. The succession of waves of overexpansion followed by financial panic, show that the market tends to fluctuate much more than economic fundamentals would justify.

The costs of this volatility are high for the developing countries. Key macroeconomic variables (such as the exchange rate and the prices of assets) tend to move away from their long-term equilibria. The most serious potential danger is that, if flows reverse abruptly, this may set off banking and financial crises that cause great disruption to the countries directly affected, and undermine the vitality of world development.

There is increasing need to find new institutional arrangements that minimize the risks of foreign exchange and financial crises. This is a good time, then, to rethink international financial arrangements, but not a good time for further liberalization of the financial markets.

Beyond the need to improve crisis management, there are two points that we stress. First, the emphasis should be on guiding the boom: the crisis is usually the result of a badly managed boom. Second, the absence of a proper international regulatory framework, justifies countries adopting national measures aimed at controlling unsustainable booms. Noteworthy are the reserve requirements on capital inflows, that Colombia and Chile have been utilizing with success. This note presents proposals in both domestic and international dimensions.

INTRODUCTION

Opening up the capital account can bring great benefits to the world economy. Most importantly, it can ease the flow of funds from countries with an abundance of capital to those suffering from scarcity, thereby improving the efficiency of resource allocation and increasing productivity. It allows developing countries access to external savings to supplement domestic savings, enabling them to increase their investment and growth. However, the integration of international capital markets can also entail significant costs, if it does not pragmatically allow for the specific nature and capacity to respond of different markets at varying stages of development.

Finance has been at the heart of the economic crises of international scope. The financial dimension played a key role in the 1930s depression and the developing country debt crisis of the 1970s. In the present decade, finance has again been a key factor in both the Mexican foreign exchange crisis and the current Asian crisis. The cost for the Asian countries most directly affected will be high. The countries involved, moreover, have been among the most dynamic in the world in terms of export growth in the 1990s. But the crisis is also having an impact on the world at large. Projections of world GDP growth for 1998 made since the Asian crisis began are from 0.3 to 0.8 points lower than those made earlier. This might seem a small percentage, but when applied to total world GDP, it represents a huge sum: a drop of one-half of a percentage point would be the equivalent of $150 billion in output lost in 1998 alone.

1. The volatility of the present international financial system

The recent crises have turned the spotlight on two problems: the great imperfections of the international capital market and the great vulnerability of developing countries to international capital shocks. The first of these problems is reflected in the volatility that has characterized the capital market in recent decades. The succession of waves of overexpansion followed by financial panic, show that the market tends first to grow and then to contract more than the economic fundamentals would justify in either direction. The volatility has to do with the nature of finance, but it is aggravated by the absence of institutions equipped to regulate a financial market so sophisticated and yet so unstable. In fact, it reflects inadequate macroeconomic coordination among the nations most influential in world markets and the limitations of international institutions in the areas of regulation, policy coordination and dissemination of information. There is no international institution working to avoid unsustainable financial booms, and the International Monetary Fund has only limited capacity to handle the ensuing crises. These deficiencies undermine the possibility of a balanced and efficient process of globalization.

The risk-rating agencies, which are among the most influential generators of market information, tend to accentuate these tendencies, as was demonstrated in a recent study by the Development Centre of the Organisation for Economic Co-operation and Development (OECD). Rating agencies and financial market traders play an essential microeconomic role in development. Nevertheless, perhaps without meaning to, they also play a macroeconomic role. The ratings of the agencies and their expectations, widely communicated in the economic press, tend to increase the

financial flow towards "winner" countries, thereby supporting a process that may appear highly efficient and sustainable (offering good profit margins and credit collateral supported by high prices of assets and low prices of liabilities in dollars), but is in reality generating bubbles which sooner or later are bound to burst. At this point, all these signals, including the risk ratings, will be reversed, accentuating the crash and deepening the crisis.

From the standpoint of the developing countries, the costs of this volatility are high. In capital boom phases, key macroeconomic variables (such as the exchange rate and the prices of assets) tend to move away from their long-term equilibria. The most serious potential danger is that, if flows drop or, worse, reverse abruptly, this may set off banking and financial crises that cause disruption and great costs to the countries directly affected. The resulting uncertainty ultimately undermines the vitality of the development process.

The recipient countries have some leeway in determining their national policies with respect to capital flows. They may passively allow external changes to be transmitted to their domestic markets, or they may attempt to moderate or spread their effects over time, influence the composition of flows and soften their impact on the exchange rate and aggregate demand. The predominant trend has been that recipient countries are urged to adopt -and praised for adopting- a policy of accepting all the financial resources that they are offered. Under pressure to open up their capital account, even in the absence of adequate domestic prudential regulation, they have been pushed into disequilibrium, which then triggers the crisis. Afterwards, during the periods of massive capital outflows, they are blamed for going too deeply into debt. There is an obvious contradiction between the two attitudes. There is also a paradox in the fact that more energy is spent resolving the crises than in preventing them. The big reward is, evidently, in preventing crises.

The costs of instability are high for the international community and the international capital markets, but even higher in terms of stable development of the world economy. There is increasing agreement on the need to find new institutional arrangements that minimize the risks of foreign exchange and financial crises, and thus maximize the benefits of capital flows.

2. Time for wise decisions that will benefit all concerned

This is a good time, then, to rethink international financial arrangements, but not a good time to contemplate further liberalization of the financial market, a topic now being debated in connection with changing the statutes of the International Monetary Fund (IMF) to give it a mandate with respect to capital account convertibility.

Beyond the need to improve crisis management and to make adjustment policies more pragmatic, there are two further points that should be made. The first is that the emphasis should be on managing the boom and not the bust: the crisis is usually the inevitable result of a badly managed boom. This is a point that should be stressed, since all existing institutions, one way or another, and the IMF in particular, have been designed to manage crises, and we lack instruments suited to sound the alarm about imbalances that may be brewing, and thus prevent in time the development of unsustainable booms. The second point is that the absence of a proper regulatory

framework on the international level, justifies countries adopting national measures aimed precisely at controlling booms that the authorities consider unsustainable. Noteworthy among these are the systems of reserve requirements on external liabilities, that Colombia and Chile have been utilizing with success.

Excessive concentration on crisis management obscures a fact that should be obvious, namely, that the authorities have greater room for manoeuvre in boom times than in crises. A boom characterized by overexpansion of public and private expenditure accentuates the cycle, inevitably generating a contractionary adjustment later, as severe as much as the previous expenditure was excessive. Thus, an unsustainable increase in public expenditure, based on transitory tax revenues and exceptional access to external credit, leads to a significant adjustment later. Excessive private-sector indebtedness, based on an underestimation of the risks associated to a rapid increase in the stock of foreign liabilities, leads to a severe credit contraction later, generally accompanied by a deterioration in the quality of bank portfolio, which can generate losses equivalent to large proportions of GDP. Overvaluation of the currency, based on transitory capital inflows or exceptionally high prices for export products, leads to heavy pressure on the exchange rate or on interest rates, once the transitory conditions change.

When the situation begins to deteriorate, and even more when a crisis breaks out, the economic authorities have few options, and those options tend to have negative effects on growth (such as increased interest rates, cuts in public expenditure and/or the collapse of national currencies). The key to the successful management of volatility, therefore, is prudence and the use of appropriate instruments during boom periods.

3. A proposal for stable and sustainable financial development

The fundamental challenge for the management of external vulnerability is to design appropriate instruments for handling international and domestic booms.

a. National financial arrangements

Instruments of this type must, first of all, include mechanisms to sterilize transitory fiscal revenues. The partial experience gained from stabilization funds for fiscal revenue deriving from commodities, should be extended to the management of transitory tax receipts. This also indicates that fiscal objectives should be established in function not of the current fiscal deficit, but of the structural deficit, as to some extent is the case in the OECD countries. Furthermore, many countries may find it attractive to offset, totally or partially, either expansionary or contractionary short-term trends in private expenditure by compensatory movements in public expenditure or revenue.

As far as monetary policy is concerned, its capacity to play a countercyclical role is fairly limited in face of large capital surges. Nevertheless, measures can be introduced which give it greater autonomy in this respect. One such measure is the use of mechanisms to discourage excessive inflow of short-term capital, such as the reserve requirements in Colombia and Chile and variable taxes in Brazil. In spite of their flaws, there is growing consensus that such mechanisms

play a positive role: they discourage excessive inflows and decrease the proportion of short-term flows. The latter effect, in particular, makes a country less vulnerable to foreign exchange crises. Discouraging excessive capital inflows, moreover, softens pressures to appreciate the national currency excessively; this in turn contributes to maintaining export competitiveness and dynamism, and helps control the size of the current account deficit.

As has been frequently pointed out, strong prudential regulation of the financial system is a basic key to preventing intermediaries taking on unmanageable risks during boom periods. The financial openness of developing countries should therefore be strictly conditional upon the prior existence of strong prudential regulation. Furthermore, it is not only macroeconomic policy that must adapt to the new context of volatility; the regulation and supervision of domestic financial systems must also do so, incorporating more countercyclical elements.

We wish to emphasize three possible components. The first is to set required bank ratios of capital to risk-weighted assets higher than the Basel requirements, since foreign exchange crises in developing countries can have a particularly negative effect on domestic bank assets. The second is to establish stricter prudential supervision on external short-term credits, especially those that are intermediated through the national banking system and are not associated with international trade transactions. The third consists of upper limits to the reference price of assets used as collateral for loans or other financial transactions, if the value of these assets -for example, real estate and shares- fluctuates widely over the business cycle.

b. *International financial arrangements*

Although the emerging countries can take effective measures to improve the management of financial volatility, their scope for action is limited. For this reason, it is becoming increasingly apparent that such measures taken by countries which receive inflows must be complemented by reforms to international financial arrangements.

In particular, there is increasing consensus that in certain circumstances the international capital markets are badly flawed. Recent experience during the Asian crises and the previous Mexican peso crisis confirm this. Asymmetrical information is particularly serious in international capital markets. It can lead to a situation in which changes in financial agents' expectations are much greater than changes in the fundamentals of the economies in which they are investing. Added to this is the "herd effect", whereby investors move massively between different national markets in moments of tension. As a result, capital flows to emerging economies -even those that are relatively well managed, with high growth rates, such as the Asian economies- tend to be highly volatile.

The existence of major flaws in international capital markets clearly justifies two types of measures. On the one hand, it implies the need for a considerable expansion of International Monetary Fund resources, to ensure that it can play its role of international lender of last resort effectively. This is crucial to reduce the contagion effects of large-scale exchange rate and financial

crises in individual countries to other emerging economies. Furthermore, there is an urgent need to improve the capacity of the IMF to foresee cases of growing macroeconomic disequilibria.

On the other hand, if the International Monetary Fund is to act as a international lender of last resort, steps should be taken to reduce the likelihood of "moral hazard" -that is, international private investors and lenders taking on excessive risks, knowing that they will be rescued if the situation becomes critical. In the event of a crisis, private lenders should do their part to overcome it by renewing loans as they become due without demanding higher interest or government guarantees, so that the resources of international financial institutions and Governments can be devoted to financing the recovery of economies in crisis, rather than to paying off prior debts. Naturally, the ideal is to prevent this from occurring, by taking action at the international level during periods of excessive optimism, in order to moderate the cycle of capital flows to emerging economies, and thus ensure that such flows are sustainable.

For this reason, it is important to improve and above all complete international prudential regulation arrangements. There appear to be two topics that require priority attention. First, it seems essential to improve the existing prudential supervision and regulation of short-term international credit in the developed countries. Second, some degree of prudential regulation of the portfolio investments of institutional investors, such as mutual funds, would also appear to be vital. This could be achieved through variable liquidity requirements linked to the weighted average of the country risk of portfolio investment in developing countries, which should be applied to institutions such as mutual funds. The risk evaluation would vary for different emerging economies and would be modified periodically, in line with changes in the macroeconomic risks. It would take account of such factors as the magnitude of the current account deficit and of external liabilities as a proportion of GDP, the maturity profile of the debt, the fragility of the country's banking system, and increases in share prices higher than justified by companies' operational balances. Such liquidity requirements would be applied by the securities control agencies of the countries of origin of the funds, in consultation with the central banks, the International Monetary Fund and the Bank for International Settlements. There is a parallel here with the prudential measures of the central banks of developed countries, whereby provisions weighted by risk are required to balance possible losses resulting from bank loans to developing countries. The prudential requirements for institutional investors would follow the same principle, but would be duly adapted to the institutional characteristics of mutual funds.

As the liquidity requirements would vary with the perceived macroeconomic risk, if the macroeconomic variables in a country started to deteriorate, the foreign inflows would gradually decline, since the weighted risk would gradually rise, thus raising the liquidity requirements. This would encourage the recipient country to correct macroeconomic imbalances at an early stage. There would be less instability in flows and, as a result, less likelihood of costly currency crises.

The prudential supervision of international credit and capital markets could be complemented with an international tax measure. A small tax on all foreign currency transactions at the global level would act as a relatively strong disincentive to very short-term speculative flows, and would have a minor impact on long-term flows. Such a tax would increase somewhat the

autonomy of national economic authorities in making monetary policy; moreover, by cutting back the more volatile flows, it would help emerging economies' exchange rates to reflect long-term fundamental variables to a greater degree, and to a lesser degree marked changes in short-term perceptions of risk or profitability.