Confronting Chaos

The Imperative of Reining in the Global Financial System

by Martin Khor

WHILE MUCH OF ASIA STRUGGLES through severe economic crisis, international financial institutions, development agencies and development experts are engaged in their own struggle over who and what policies should shoulder the blame for Asia's economic catastrophe.

Although many prominent academics, such as Harvard's Jeffrey Sachs and MIT's Paul Krugman, have criticized International Monetary Fund (IMF) recessionary policies, most United Nations reports have focused primarily on the social aspects of the crisis, or describe the economic issues. Thus, with the exception of dissident noises from the World Bank's chief economist, Joseph Stiglitz, most of the institutional economic analysis receiving wide publicity has come from the International Monetary Fund.

In September, however, the United Nations Conference on Trade and Development (UNCTAD) joined the debate in a powerful way with release of its Trade and Development Report 1998.

The UNCTAD report examines the causes of the crisis, locating these in the very system of global finance. It criticizes the IMF-led international response to the crisis. And it provides several proposals for the appropriate management and prevention of such crises.

Among the suggestions are the establishment of a mechanism allowing countries on the brink of crisis to declare a "debt standstill," during which creditors are obliged to give time for a restructuring of debt repayments, similar to the Chapter 11 procedures in the United States bankruptcy law.

Another proposal is that developing countries make use of capital controls as part of their "armory" in preventing or helping resolve financial crises.

BLAMING THE IMF

UNCTAD argues that the East Asian experience is only one of a series of financial crises (for example, in the Southern Cone of Latin America in the late 1970s and early 1980s, Latin America in the 1980s, European countries in 1992, Mexico in 1994) of the past two decades.

These crises are caused by the intrinsic and volatile nature of the global financial system, which moved to its current state after the closure of the fixed exchange rate system in the early 1970s.

The Asian crisis, says UNCTAD, began with financial liberalization (meaning countries lifted restrictions on the inflow and outflow of capital), causing a build-up of vulnerability of the countries to external forces. When large inflows of short-term capital took place, it led to an asset price bubble (with real estate and other investments soaring in value) that broke when speculative currency attacks caused sharp depreciations as foreign investors fled. These depreciations then spread via "contagion" to other countries, as international investors suddenly became fearful of losing their investments in other nations.

Once the countries fell into crisis, the IMF's response (monetary and fiscal tightening and high interest rates) made it worse.

In one of the deepest critiques of the IMF approach, UNCTAD says: "The situation was characterized by a stock

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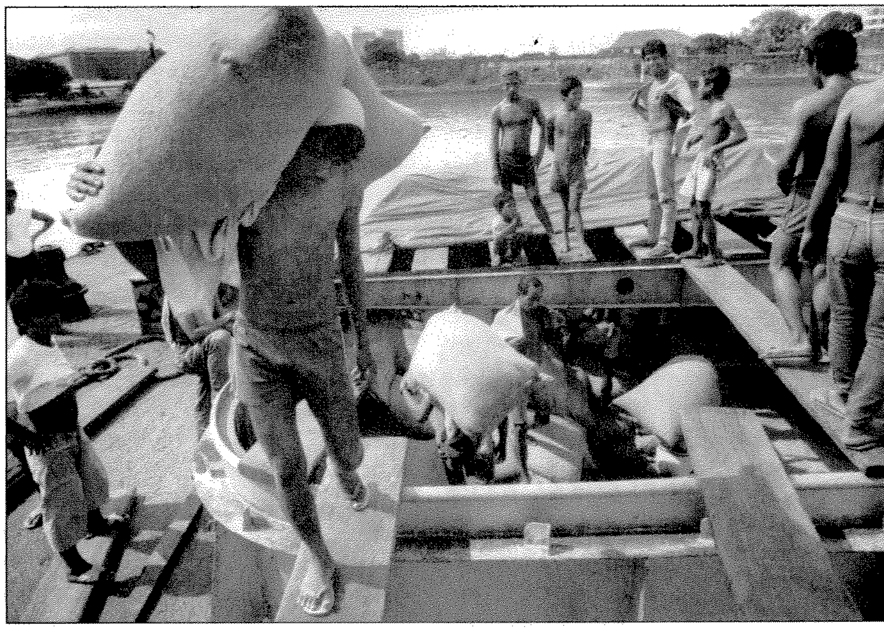

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Laboring in the Philippines.

disequilibrium rather than a flow imbalance that could be corrected by expenditure reduction." In other words, mere reduction in government spending or cutbacks on imports would not be sufficient to solve the problem.

"At the new exchange rates, the stock of outstanding foreign debt became too large to be supported by expected income flows," the report explains. "The value of firms, and asset prices more generally, thus declined. Since these assets had been the collateral for much of the increased lending, the quality of bank loans automatically deteriorated."

The IMF response — that countries should raise interest rates to stay attractive to foreign investors — made things still worse, the report argues. "Rather than ease the burden of refinancing on domestic firms by granting additional credit, the recommended policy response was to raise interest rates. This depressed asset prices further and increased balance sheet losses of firms and their need to repay or hedge their foreign indebtedness quickly by liquidating assets and selling the domestic currency."

Moreover, says the report, instead of the IMF loans going to support the new exchange rates, in East Asia the exchange rates were left to float. "Thus rather than guaranteeing the new exchange rate, the Fund's lending has been aimed at ensuring the maintenance of the domestic currency's convertibility and free capital flows, and guaranteeing repayment to foreign lenders."

In the end, foreign investors' interests were protected. Foreign lenders, "unlike domestic lenders, emerge from the crisis without substantial loss, even though they had accepted exposure to risk just as other lenders had done," states the UNCTAD report.

According to UNCTAD, the crisis was initially one of liquidity rather than of solvency. If they had been given sufficient time to realize their investments, the countries would have been able to generate foreign exchange to repay their external debt. Over time, a relatively modest exchange rate adjustment of 10 to 15 percent would have been sufficient to restore competitiveness.

However, the UNCTAD report asserts,"the use of high interest rates, the extent of currency devaluation and the reduction in growth rates that created conditions of debt deflation quickly acted on financial institutions and company balance sheets to create a solvency crisis."

PROTECTING DEBTORS

In other words, in this analysis, the crisis-stricken countries that sought IMF funds were never given a proper chance. What would that chance have looked like?

UNCTAD says that given the sharp attacks on the currencies, "the appropriate action would be to move quickly to solve the intertemporal problem by introducing a (debt) standstill and bringing the borrowers and lenders together to reschedule, even before the commitment of IMF funds."

It adds that a combination of rapid debt restructuring and liquidity injection to support the currency and provide working capital for the economy would also have made it possible to pursue the kind of policies that enabled the United States to recover quickly from a situation of debt deflation and recession in the early 1990s.

In a chapter on "the management and prevention of financial crises," the report says that theoretically there are four lines of defense an indebted country can take if faced with a massive attack on its currency:

- Domestic policies (especially monetary and interest rate policy) to restore market confidence and halt the run;
- Maintain sufficient foreign reserves and credit lines;
- Use of an international lender-of-last resort facility to obtain the liquidity needed;
- A unilateral debt standstill (temporary halt on debt repayments) accompanied by foreign exchange restrictions, and initiation of negotiations for an orderly debt workout.

Examining each of these options, UNCTAD finds that although the first three are theoretically possible, in reality they either don't work or are not in existence. Therefore, in the present crisis, the fourth option should be considered seriously.

The first option (tight monetary policy and high interest rates), favored by the International Monetary Fund, has not worked for ailing Asian countries. On the contrary, says UNCTAD, higher domestic interest rates increase the financial difficulties of the debtors and reduce their incomes and net worth, increasing the likelihood of default. "Thus, they provide no incentive for foreign lenders to roll over their existing loans or extend new credits."

The second option (maintaining high reserves) might work if the reserves are large enough and have been built up through trade surpluses, as a few countries have done. But there are many problems if reserves are increased through borrowing: the cost for carrying such reserves would be very high, the reserves may not be enough to stem a big attack or large fund withdrawals and moreover the borrowed funds in the reserves are also vulnerable to withdrawals.


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Hawking clothing in Moscow.

Regarding the third option, there has not been an international lender of last resort to provide liquidity to stabilize currencies in developing countries facing currency crises. Instead, after the currency has collapsed, there have been IMF-coordinated bailouts.

These bailouts are however designed to meet the demands of creditors and to prevent default, says UNCTAD, and they pose three problems: they protect creditors from bearing the costs of poor lending decisions, putting the burden entirely on debtors; they create "moral hazard" for international lenders, encouraging imprudent lending practices; and the funds needed are increasingly large and difficult to raise.

UNCTAD thus proposes the fourth option: setting up an international insolvency procedure whereby a country unable to service its foreign debts can declare a standstill on payment and be allowed time to work out a restructuring of its loans, whilst creditors would agree to this "breathing space" instead of trying to enforce payment.

What UNCTAD is proposing is actually an extension of national bankruptcy procedures (similar to Chapter 11 of the U.S. Bankruptcy Code) to the international level for countries facing debt difficulties.

Bankruptcy procedures are especially relevant to international debt crises resulting from liquidity problems as they are designed to address financial restructuring rather than liquidation.

In the U.S. Code, no receiver or trustee is appointed to manage the debtors' business and debtors are left in possession of their property. The procedure is to facilitate a three-stage orderly workout.

In stage one, the debtor files a petition and there is an automatic standstill on debt servicing, giving debtors-in-possession a breathing space from their creditors, who are not allowed to pursue lawsuits or enforce debt payment. This prevents a "grab race" by creditors, and the debtor can formulate a reorganization plan.

In stage two, the Code provides the debtor with access to working capital to carry out its operations, by granting a seniority status to debt contracted after the petition is filed. This debtor-in-possession financing can be granted if approved by the court and does not depend on the existing creditors' agreement.

Stage three sees the reorganization of the debtor's assets and liabilities and its operations. The plan does not need unanimous support by creditors (acceptance by 50 percent of the creditors in number and two thirds in amount of claims is sufficient) and the debtor can get court approval of the plan.

These procedures are used not only for private debt. Chapter 9 of the U.S. Code deals with public debtors (municipal authorities), applying the same principles as Chapter 11. The recent successful workout of the Orange County, California debt was under Chapter 9. There are similar arrangements in most other industrial countries.

UNCTAD proposes an international mechanism using the same principles. One suggestion discussed in the report is an international bankruptcy court that applies an international Chapter 11 drawn up in a United Nations treaty.

The court would have powers to impose automatic stay, allow debtor-in-possession financial status and also restructure debt and grant debt relief.

UNCTAD says a less ambitious and perhaps more feasible option is to set up a framework to apply key insolvency principles (debt standstill and debtor-in-possession financing) combined with established debt-restructuring practices, with the IMF playing a major role.

However, there are many objections to giving so much power to the IMF, on grounds of conflict of interest (as the IMF is also a creditor, imposes conditionality and its shareholders are countries affected by its decisions).

An alternative, which UNCTAD seems to favor, is to set up an independent panel to determine if a country is justified (according to principles in the IMF's articles of agreement) in imposing exchange restrictions with the effect of debt standstills.

The decision for standstill could be taken unilaterally by the debtor country, then submitted to the panel for approval within a period.

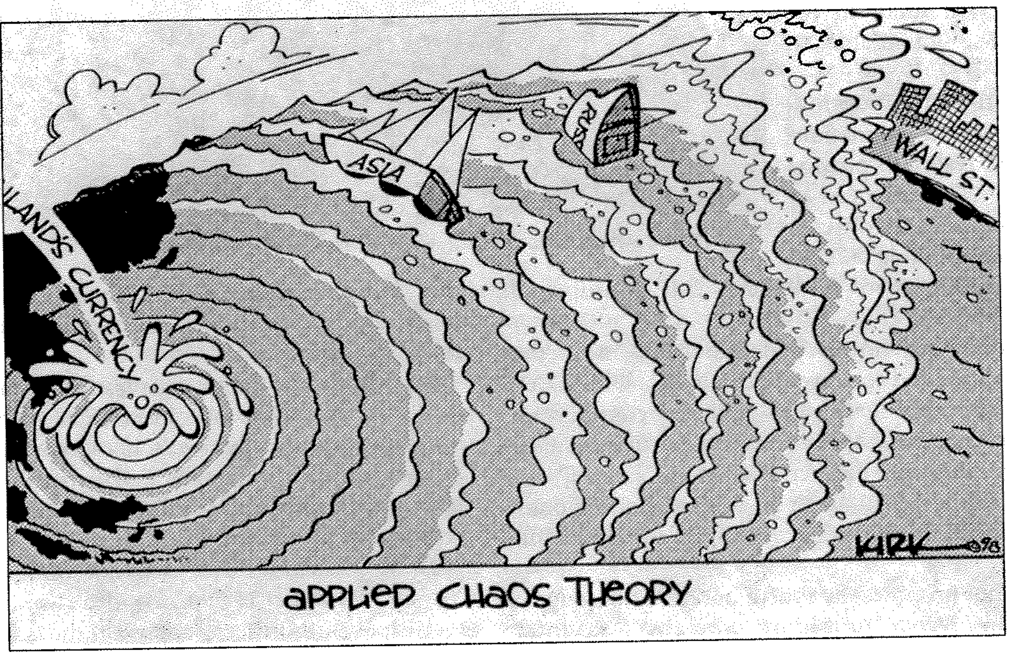
These debt standstills should be combined with debtor-in-possession financing (loans which would not go to pay off outstanding debt) so the debtor country can replenish its reserves and get working capital.

UNCTAD argues that the IMF funds for such emergency lending would be much less than the size of bailouts.

As regards government debt to private creditors, reorganization can be carried out through negotiations with creditors, with the IMF continuing to play an important role of bringing all creditors to meet with the debtor government, UNCTAD recommends.

For private sector debt, negotiations could be launched with private creditors immediately after the imposition of debt standstill.

If a Chapter 11 type of international bankruptcy procedure were in place, a country facing the imminent prospect of default could declare a debt standstill, get court protection from creditors, obtain fresh working capital, restructure its debts, and plan for economic recovery, which in turn would enable the country eventually to service the debts adequately.



With such procedures, countries facing a "cashflow problem" can nip it before it worsens and thus prevent a major crisis. Both the debtor country and its creditors gain.

Contrast this with the present messy situation, where in the absence of a fair system, all creditors rush to exit the country, each hoping to recoup its loan before other creditors take out their loans.

And then when the debtor country has its back to the wall, the creditors as a group usually demand, in a restructuring plan, that the government not only pay higher interest on its loans, but also take over or guarantee the payment of the loans contracted by private banks and firms.

It might be argued that a country already near default could unilaterally declare a debt moratorium and then dictate its own terms for debt restructuring. However, few countries have the courage to do so, as the foreign banks may probably gang up and deny any new credit, thus threatening the countries' capacity to pay for essential imports.

In August, however, a rapidly ailing Russia did declare a moratorium not only on its foreign debt but also on its domestic government bonds (most of which are held by foreign investors), at the same time as floating the ruble, which has since devalued sharply. It is also stating the terms of debt restructuring.

The foreign banks have expressed outrage at these terms and are clamoring to negotiate with the government, even threatening to seize the assets of Russian banks located abroad.

CALLING FOR CAPITAL CONTROLS

In conjunction with the debt standstill, UNCTAD urges that developing countries should be allowed to introduce capital controls, as these are "an indispensable part of their armory of measures for the purpose of protection against international financial instability."

Although it was released on September 16, the UNCTAD report was finalized in July. The writing of the report thus predates the sweeping capital control measures taken by the Malaysian government on September 1. The new Malaysian policy seems to be consistent with the rationale and advice provided by the UNCTAD Report, which in turn marks the first time since the Asian crisis began that an influential international agency has called for the use of capital controls.

The report notes that good economic fundamentals, effective financial regulation and good corporate governance are necessary to avoid financial crises, but by themselves they are not sufficient.

Experience shows that to avoid these crises, a key role is played by capital controls and other measures that influence external borrowing, lending and asset holding.

Control on capital flows are imposed for two reasons: firstly, as part of macroeconomic management (to reinforce or substitute for monetary and fiscal measures) and secondly to attain long-term national development goals (such as ensuring residents' capital is locally invested or that certain types of activities are reserved for residents).

Contrary to the belief that capital controls are rare, taboo or practiced only by a few countries that are somehow "anti-market," the reality is that these measures have been very widely used.

UNCTAD notes that they have been a "pervasive feature" of the last few decades.

In early post-war years, capital controls for macroeconomic reasons were generally imposed on outflows of funds as part of policies dealing with balance of payments difficulties and to avoid or reduce devaluations.

Rich and poor countries alike also used controls on capital inflows for longer-term development reasons.

- When freer capital movements were allowed from the 1960s onwards, large capital inflows posed problems for rich countries such as Germany, Holland and Switzerland. They imposed controls such as limits on non-residents' purchase of local debt securities and on bank deposits of non-residents.
- When faced with a surge of short-term capital inflows, Malaysia in January 1994 imposed an array of capital controls. Among the measures: banks were subjected to a ceiling on their external liabilities not related to trade or investment; residents were barred from selling short-term monetary instruments to non-residents; and banks had to deposit at no interest in the central bank monies in ringgit accounts owned by foreign banks. These measures were gradually removed from 1995 onwards.
- When Chile was faced with large capital inflows in the early 1990s, it took measures to slow short-term inflows and even to encourage certain types of outflows. The main step was that foreign loans entering Chile were subjected to a reserve requirement of 20 percent (later raised to 30 percent). In other words, a certain percentage of the each loan had to be deposited at the central bank for a year, without being paid any interest.
- Also to prevent excessive inflows, Brazil in mid-1994 imposed controls such as an increase in the tax paid by Brazilian firms on bonds issued abroad, a tax on foreigners' investment in the stock market, and an increase in tax on foreign purchases of domestic fixed-income investments.
- The Czech Republic faced large inflows in 1994-95 and it imposed a tax of 0.25 percent on foreign exchange transactions with banks, and also imposed limits on (and the need for official approval for) short-term borrowing abroad by banks and other firms.

Controls on inflows of foreign direct investment and portfolio equity investment may take the form of licensing, ceilings on foreign equity participation in local firms, official permission for international equity issues, differential regulations applying to local and foreign firms regarding establishment and permissible operations and various kinds of two-tier markets.

Some of these controls can also be imposed on capital inflows associated with debt securities, including bonds. Such inflows can be subject to special taxes or be limited to transactions carried out through a two-tier market, with separate rules applying to foreign and domestic investors.

Ceilings (as low as zero) may apply to non-residents' holdings of debt issues of firms and government; or foreigners may need approval to buy such issues. Foreigners can also be excluded from auctions for government bonds and paper.

UNCTAD also lists other controls commonly used to restrict external borrowings from banks.

They include a special reserve requirement concerning liabilities to non-residents; forbidding banks to pay interest on deposits of non-residents or even requiring a commission on such deposits; taxing foreign borrowing (to eliminate the margin between local and foreign interest rates); and requiring firms to deposit cash at the central bank amounting to a proportion of their external borrowing.

As for controls on capital outflows, they can include controls over outward transactions for direct and portfolio equity investment by residents as well as foreigners.

Restrictions on repatriation of capital by foreigners can include specifying a period before such repatriation is allowed, and regulations that phase the repatriation according to the availability of foreign exchange or to the need to maintain an orderly market for the country's currency.

Residents may be restricted as to their holdings of foreign stocks, either directly or through limits on the permissible portfolios of the country's investment funds.

Two-tier exchange rates may also be used to restrict residents' foreign investment by requiring that capital transactions be undertaken through a market in which a less favorable rate prevails, compared to the rate for trade transactions.

Some of these techniques are also used for purchases of debt securities issued abroad and for other forms of lending abroad. Residents' overseas bank deposits abroad by residents can also be restricted by law.

PRESERVING GOVERNMENT AUTONOMY

UNCTAD concludes that recent financial crises and frequent use of capital controls by countries to contain the effects of swings in capital flows point to the case for continuing to give governments the autonomy to control capital transactions.

It questions recent moves in the IMF to restrict the autonomy or freedom of countries to control capital flows.

Ways have not yet been found at a global level to eliminate the cross-border transmission of financial shocks and crises due to global financial integration and capital movements.

Thus, concludes UNCTAD, for the foreseeable future, countries must be allowed the flexibility to introduce capital control measures, instead of new obligations being imposed on these countries to further liberalize capital movements through them.

The UNCTAD report has quite clearly made out the case for capital controls. It is important to note, however, that these controls should not be treated as a panacea that by themselves can cure recession ills.

Capital controls can also have some disadvantages, and have their own limitations. But they can be an important part of a set of policies that can protect a country facing a turbulent and hostile external situation, so that it can reduce exposure to financial and economic chaos, at least for some time. ■