

Confronting International Financial Shocks

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I. INTRODUCTION

It is an honour and a great pleasure for me to participate in this International Seminar and in particular to join in celebrating the 70th Anniversary of Banco Central de Bolivia --- a remarkable milestone. I extend my sincere congratulations to the bank on this fine occasion. The Bank's ongoing role in helping create a stable economic environment — one that promotes employment and income growth — is as important today as when it was founded in 1928 and will continue to be so in the decades ahead.

The environment in which the Bank has to achieve its goals has, of course, changed substantially over that period, particularly with respect to international developments. This is why I am pleased to have been asked to address one aspect of such international developments, namely, "Confronting International Financial Shocks".

Naturally in addressing this issue today, attention shifts immediately to the current international crisis, the Asian crisis and its international implications. This is entirely appropriate because as time has unfolded it has become apparent that the Asian crisis is much deeper and will last longer, with more international ramifications, than first appeared to be the case.

It has been suggested that I bring a Canadian perspective to this issue of confronting international financial shocks including the impact of the Asian crisis on Canada and my impressions of its implications for Latin America.

In using the Asian crisis and a Canadian perspective as starting points for considering how to confront international financial shocks the following key questions come to mind: What is it about the Asian crisis that has made it so severe and long lasting; what is it about the Canadian economy that in spite of Canada's close economic and financial ties with Asia, it has withstood the shock of the Asian crisis reasonably well; what lessons do the answers to those two questions impart to Latin American and other countries concerning how to deal with international financial shocks?

II. "LIQUIDITY", "SOLVENCY", AND "CONTAGION"

As we all know, and as is implied by the title to this Conference, capital flows are the major vehicle by which financial shocks are transmitted. Furthermore, the word "contagion" is now frequently used in describing the

transmission mechanism. I find this use of the word “contagion” to be misleading. It begs the question as to why a country should become “infected” and why some are infected much more than others.

To clarify this I find it helpful to make a distinction between “liquidity” problems and “solvency” problems that institutions and financial systems may face in the course of international financial disturbances.

Assume that a country’s macroeconomic policies (including exchange rate policies) are stabilizing in character and its financial system is sound and competitive. In such a case an international financial shock that generates substantial capital movements may still create problems. However, what will be created here are “liquidity” problems since fundamental solvency of the financial institutions is not at issue.

These can usually be managed by providing short-term foreign exchange support, “lender-of-last-resort” support to financial institutions individually, and increased “liquidity” from the central bank to the system as a whole. Once the initial impact is over this excess liquidity can be withdrawn and so made harmless for future economic stability.

An example of this was the sharp decline in international stock markets in October 1987. It was responded to swiftly by the coordinated action of the major international central banks in the form of an increase in “liquidity” to accommodate the fear-driven move into cash. The stock market shock, even though it was the sharpest since the depression of the 1930s, soon moved into history.

But a quite different situation emerges if the impact of capital flight falls on a country with weak macroeconomic and exchange rate policies, a weak industrial structure, and a weak and vulnerable financial system. Such a country possesses little “immunity” to the destabilizing impact of a flight of capital and institutions that previously appeared to be operating satisfactorily suddenly face the risk or reality of insolvency.

Permanent solutions to the conditions that have led to the risk of insolvency are not found in the provision of liquidity — except to buy time to mount permanent structural solutions. Such solutions are found in the readjustment of inappropriate macroeconomic, including exchange rate policies, and in addressing industrial and financial system structural rigidities and

weaknesses. It is these weaknesses that lie at the heart of the financial crisis and not financial shocks emanating from abroad. The term “contagion” in such circumstances misrepresents the nature of the problem.

At this level of generality it is apparent that strategy for confronting international financial shocks must have three major elements. First, it must have available for rapid use mechanisms, both domestic and multilateral, for providing emergency liquidity. Second, it must seek to establish a stable macroeconomic and exchange rate environment. Third, it must create a financial system, including a financial regulatory regime, that meets the efficiency and safety standards needed to survive and prosper in today's highly competitive international financial markets. These elements are essential for retaining the confidence of international financial markets and investors — a prerequisite, as discussed below, for successfully confronting international financial shocks.

III. UNIQUENESS AND UNPREDICTABILITY OF FINANCIAL SHOCKS

Confronting international financial shocks would be greatly facilitated if one could forecast their emergence with a degree of certainty and if they were all the same in character. Unfortunately history tells us that neither is the case.

As we all know the current Asian crisis is not the first financial crisis to come along. It is simply the latest of a very long list of international financial shocks that history, both recent and distant, has recorded, going back as far as the international repercussions of the “tulip mania” in Holland of 1634-1636 and the “South Sea Bubble” in England of 1720.

The Baring Brothers crisis of November 1890 (not the one of 1994), and the failure of banks and brokers in London and New York at that time, arose out of sudden shifts in international financial flows¹. Indeed, from the second half of the nineteenth century until the stock market crash of 1929 there was an enormous amount of international lending and with it, from time to time, international borrowers in financial difficulties, as for example utility companies in North and South America and some sovereign authorities as well.

¹Milton Friedman and Anna Jacobson Schwartz, A Monetary History of the United States, 1867-1960, Princeton University Press, Princeton, 1963, p.104 .

The Great Depression of the 1930s, particularly after the collapse of Austria's largest bank, the Credit-Anstalt in May 1931, and the collapse of the Gold Standard, had world-wide international financial repercussions. Credit for trade financing and previous substantial flows of longer term international capital virtually vanished and even sovereign authorities had great difficulty refinancing their international debt. Strong and weak debtors alike were suddenly confronted with international shocks that many of them could not and did not survive.

Still clearly in our minds is the energy crisis of the 1970s, the lesser developing country (LDC) debt crisis of the 1980s and the United States Savings and Loan crisis, the currency crisis in the European Monetary System in 1992, the Mexican peso crisis of 1994, and in earlier post-war years the recurring "sterling" crises.

Individual shocks such as the failure of the Bank of Credit and Commerce International in 1991 and Barings PLC in 1994 not to mention the various individual failures that have recently emerged in Asia and elsewhere underscore the role of weak internal controls in such cases, particularly as concerns their international operations.

But in spite of all this long experience with crises, history tells little about what the character of the next crisis will be when it comes. This is because no two of those major crises were exactly alike and in some cases they differed greatly one from another. The Asian crisis, as I discuss below, has elements that I believe make it different from most other past crises, including the 1980s LDC debt crisis. Therefore the mix of policies that were appropriate for addressing past crises might not be adequate for the next one.

Also in spite of this historical experience, few if any were able to predict the timing of the collapse of Japanese financial and real asset prices in the early 1990s or the collapse of markets in Thailand in 1997; and research has failed to identify reliable predictors of foreign exchange and financial market crises². I use the phrase "timing of the collapse" deliberately because the underlying developments that increased the risk for such a collapse had been evident for some time.

²See Ilan Goldfajn and Rodrigo O. Valdes, "Are Currency Crises Predictable?", International Monetary Fund, 1997 and Steven Radelet and Jeffrey Sachs, Harvard Institute for International Development, "The Onset of the East Asian Financial Crisis", March 30, 1998.

These included over-valued financial and real estate prices and exchange rates, high ratios of short-term external debt to foreign exchange reserves, lack of transparency in banking operations, growing current account deficits, accelerating domestic credit and declines in borrowing spreads that made little economic sense³. But the point at which such weaknesses finally cause private sector foreign and domestic investors to lose confidence in the country and move out of its markets, leaving chaos behind, cannot be known.

Since no two crises are exactly alike, strategy for confronting international financial shocks must include speedy but thorough analysis of the inherent nature of the crisis, so that appropriate responses can be mounted; and also, having in mind that forecasting the timing of a crisis is next to impossible, it must include the establishment of mechanisms that permit a speedy response particularly since the economic costs of delay, as I discuss below, are great.

IV. THE FREQUENCY OF INTERNATIONAL FINANCIAL SHOCKS

In thinking about how to confront international shocks and crises it is unwise to believe that once the Asian crisis has passed, no others will arise. Periodic international financial crises are likely to remain a feature of our economic environment in the years ahead. History alone suggests this.

But an additional reason today is the growing impact of international capital flows, particularly private sector capital flows. These have become so huge by past standards that disruptions to them have more serious and more widespread consequences than in previous decades.

Unfolding news, accurate or not, about the financial conditions of international debtors and creditors or of international financial institutions servicing them now invites a swift response from international financial market forces. The margin for manoeuvre of individual debtors and creditors, sovereign and private, has been much reduced because of the sensitivity of financial markets and the speed and volume of their response.

³Cf. Gazi Ercel, Governor, Central Bank of the Republic of Turkey, Address to the Euromoney Conference: Investing in the Future, Istanbul, June 3, 1998.

The Chairman of the United States Federal Reserve System, citing the Asian and Mexican crises as examples, has portrayed this growing sensitivity to financial disturbances graphically:

...With the new more sophisticated financial markets punishing errant government policy behavior far more profoundly than in the past, vicious cycles are evidently emerging more often. For once they are triggered, damage control is difficult. Once the web of confidence, which supports the financial system, is breached, it is difficult to restore quickly....At one point the economic system appears stable, the next it behaves as though a dam has reached a breaking point....The United States experienced such a sudden change with the decline in stock prices of more than 20 percent on October 19, 1987.⁴

Indeed there is compelling evidence that the frequency of financial crises has been increasing. It has been found that over the period 1980-1996 at least two thirds of IMF member countries experienced significant banking sector difficulties and that the incidence of such difficulties was significantly higher in the 1980s and 1990s than in the 1970s.⁵

Since 1980 there have been about 67 banking crises of which 52 were in developing countries⁶. There is strong reason to believe that this frequency has arisen in part because of the increased integration of capital markets and the greatly increased size of private sector international capital flows — both being permanent developments, not ones that will fade away.

What all this implies is that the monetary and fiscal authorities of nation states, as well as private sector participants in the international financial system, must have strategies consistent with this phenomenon of global financial integration and the shocks that are likely to emerge from it. It

⁴ Alan Greenspan, Chairman, Federal Reserve Board, Address before the Annual Financial Markets Conference of the Federal Reserve Bank of Atlanta, Miami Beach, Florida, February 27, 1998.

⁵ See Morris Goldstein and Philip Turner, Banking Crises in Emerging Economies: Origins and Policy Options, Bank for International Settlements, October 1996, p.5 and the references there cited.

⁶ See Jeffrey A. Frankel, Address to Conference on "Preventing Bank Crises: Lessons from Recent Global Bank Failures" sponsored by the Federal Reserve Bank of Chicago and the World Bank, Lake Bluff, Illinois, June 11, 1997.

would be unwise for them to assume that conditions causing such shocks will be less troublesome in the future than in the past.

V. THE ECONOMIC COSTS OF FINANCIAL CRISES

One recurring characteristic of past crises has been the great reluctance of authorities to take timely action. Absence of strong political leadership, for whatever reason, has been a significant factor in explaining poor management of financial shocks. It is as if the authorities and the public generally are not fully cognisant of the huge economic costs of crises nor of how much less costly timely action would be. Because the actual breaking point of a crisis situation cannot be forecast accurately, even though the building up of conditions that risk a crisis sooner or later can be identified, there is an innate tendency for authorities to wait until the crisis erupts before taking strong action, and often there is delay even then. The recent Japanese experience, as we shall see, is a striking example of this. Such delays in part explain the enormous final economic costs of economic and financial crises.

For example, it has been found that over the last 15 years the public costs of bailing out banks in developing countries has amounted to \$250 billion; and also, that a dozen or more developing countries have lost at least 10 percent of their output in the process⁷. Japan's bailout package alone for supporting its financial institutions announced in December 1997 amounted to US \$77 billion and its non-performing bank loans currently appear to exceed US\$700 billion.

The other Asian countries caught in the crisis face relatively similar costs. Malaysia, for example, recently announced that it may have to spend an additional US\$3.8 billion on recapitalising financial institutions over the next two years and about US\$6 billion to take over non-performing loans⁸. The total clean-up costs of the US Savings and Loan system collapse is estimated at 2 ½%-3% of GDP. Spain's (1977-85) banking crisis cost about 17% of

⁷See Morris Goldstein, The Case for International Banking Standards, Institute for International Economics, April, 1997.

⁸The Wall Street Journal, July 14, 1998.

its GDP, for Finland(1991-93) it was 8%, Sweden (1991) 6%, Norway(1897-89) 4%⁹.

Also it has been estimated that the fiscal cost of adjustment programmes relating to financial crises in billions of dollars was as follows: Argentina(1982) \$13, Chile (1985) \$19.6, Colombia (1985) \$6, Venezuela (1994) \$13, Finland(1991-3) \$8.2, Norway (1988-93) \$9, United States (1991) \$5.1¹⁰. Very interesting and significant is the recent finding that the more timely actions being taken by Brazil in restructuring its financial system should involve much lower restructuring costs than the less timely actions involved in the countries noted here¹¹.

VI. MAJOR CHARACTERISTICS OF THE ASIAN CRISIS

In one important respect the Asian crisis began with the collapse of the greatly inflated Japanese financial and real estate asset prices in the early 1990s and not, as commonly assumed, with the devaluation of the bath in Thailand on July 2 1997. This is because the weaknesses in the Japanese economy and in its institutions and institutional arrangements that were revealed in the months following the collapse were very similar to the weaknesses that have now been revealed in Thailand, Malaysia, the Philippines, Indonesia and South Korea. It gradually became evident that the Japanese crisis was not just a normal cyclical correction with temporary "liquidity" problems, and it is very clear now that the other Asian countries whose crises emerged in 1997, also are not simply facing such a cyclical reverse.

There was of course the familiar macroeconomic slow-down in Japan, which normally one would expect would take just a year or two to work itself out. But what has made the Asian crisis unique is that superimposed on the cyclical weakness that followed an unsustainable credit boom, are a range of

⁹Gerard Caprio and Daniel Klingebiel(1996a), "Bank Insolvencies: cross-country Experience", World Bank, Washington, April 1996, as quoted in Morris Goldstein and Philip Turner, *Banking Crises in Emerging Economies: Origins and Policy Options*, Bank for International Settlements, Basle, October, 1996, p. 5.

¹⁰Lilian Rojas-Suarez and Steven R. Weisbrod, "Banking Crises in Latin America: Experience and Issues", Inter-American Development Bank, 1995.

¹¹Gary H. Stern, President, Federal Reserve Bank of Minneapolis, Address to the University of Minnesota Roundtable, Minneapolis, March 11, 1998.

structural weaknesses in the financial and industrial sectors and in the regulatory system intended to oversee them.

The weaknesses in the financial sector were aggravated by the fact that private sector international debt relative to sovereign debt was relatively much more important in the period building up to the collapse than it had been prior to the LDC debt crisis. Funds invested in it are more subject to sudden flight and so to the creation of “panic” than funds invested in sovereign debt¹².

The depth of the crisis in Japan was further aggravated by the long delays of the authorities in putting in place both macroeconomic and exchange rate policies in harmony with the deterioration in economic conditions and structural adjustment policies directed toward dealing with weaknesses in the financial system and its regulation.

I referred earlier to my unease over the use of the word “contagion” in describing the experiences of the various Asian countries. To the extent that they all suffer from generally the same economic and regulatory system weaknesses, it is incorrect to speak of contagion as the root cause of their difficulties. While countries without such structural weaknesses will still feel the normal macroeconomic effects of the Asian economic slow-down through the channels of trade there is no reason to believe that they would be otherwise affected. They might even benefit if viewed as safe havens for investments.

But one question remains. The structural weaknesses in the financial systems referred to were not new, so why had they had not created a crisis many years before? The answer appears to lie in the changes taking place in the international economic and financial environment. In particular, the volumes of international private capital flows were growing larger decade after decade. Back of this were advances in computer and communications technology that facilitated such growth and major advances in finance theory that, with the help of the computer, opened the way for the development of new and complex financial products¹³.

¹²See Gazi Ercel, *ibid.* and also Steven Radelet and Jeffrey Sachs, *ibid.*

¹³See Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Address at the Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, May 1, 1997.

It is particularly important to note that these fundamental changes in the financial system were not the result of changing regulations, but rather the result of market innovation, and therefore irreversible. The resulting explosion in private international capital flows and the complexity of financial instruments in effect tended to make obsolete past ways of doing business and past approaches to financial regulation.

Specifically, the greatly increased use by the private sector of international funding made countries much more vulnerable to capital flights; and the accelerated use by financial institutions of the more easily attainable international capital and the greater variety of financial instruments was not matched by a revamping of the regulatory systems intended to oversee them.

The resulting decline in the quality of asset portfolios, the inadequate capital bases of a large number of institutions and corporations and the use of unethical lending practices, which in themselves fed the cyclical boom, came to the fore first in Japan and most recently in other Asian countries. It partly explains both the “bubbles” in financial and real asset prices that developed in all of them and their sudden collapse when capital took flight.

Particularly striking, in the case of Japan, is how long it has taken the authorities to accept that what was going on constituted a quantum change from the past, one requiring fundamental restructuring of the financial system and its regulation. Beginning in 1979 Japan began to make minor changes in its money and capital market arrangements and in the operations of its banks and of foreign banks, but basic structures and arrangements did not change. These included a complicated structure of bank categories; layers of banking supervision including Ministry of Finance, Bank of Japan, and local governments; protracted delays in taking action when crisis loomed; regulation through collusion between the regulator and the regulated; loose corporate governance practices; and an absence of detailed reporting and lack of transparency¹⁴.

Therefore major disruptions in the financial system did not end with the 1990-1991 difficulties. For example, 1995 saw the bankruptcy of thirteen Japanese financial institutions. Then in the black month of November 1997, the large brokerage firm Sanyo Securities had to request court protection,

¹⁴ See Ulrike Schaede, “The 1995 Financial Crisis in Japan”, University of California, San Diego, February 1996.

Hokkaido Takushoku Bank announced it was closing up, and Yamaichi Securities, in business for 100 years and one of the largest brokerage firms, was obliged to announce that it was ceasing operations.

Not until November 1996 did Japan announce financial reform equivalent to the so-called “Big Bank” reform in the United Kingdom of 1986. It focuses on liberalization of markets, greater transparency and the attainment of world standards in the sector. Their new approaches include reforming the Bank of Japan and making it more independent, establishing a separate regulatory authority, and introducing a policy of “prompt corrective action” for dealing with financial institutions in difficulty¹⁵. Recently the Japanese authorities have embarked on comprehensive action for dealing with the problem of bad bank loans through establishment of a “bridge bank” along the lines of the approach used in managing the United States Savings and Loan debacle — a problem that had by then plagued the system for about seven years¹⁶. They have also encouraged mergers between major financial institutions.

In Mexico, we can recall that the peso crisis of December 1994 was greatly aggravated by the pre-existing weakness in its banking system and its regulatory system — a period when, what with the emergence of NAFTA and the confidence it tended to convey, there had been a very large inflow of private foreign capital. Similarly so South Korea, which after gaining increased respectability in becoming a member of the Organization for Economic Cooperation and Development (OECD), suddenly had access to huge amounts of foreign capital. In both cases the regulatory system did not adjust to the new reality and the result was a banking crisis. And in both cases major restructuring of the financial system has been found to be necessary and is underway.

Delay in taking strong action as soon as possible occurred in almost every country, although the degree of delay differed among them. While most began with supporting the currency through the use of foreign exchange reserves, some did not immediately accompany this with a supporting increase in interest rates. Thailand and South Korea delayed calling on the IMF for conditional assistance until their foreign exchange reserves were almost exhausted and Indonesia, while calling on IMF assistance earlier, ran

¹⁵See “Japan’s Financial Woes and the Hopes for Big Bang”, Japan Echo, Vol.25, No.1, February 1998.

¹⁶The Globe and Mail, Toronto, July 1, 1998. p.B9 .

into difficulty when doubts emerged over the implementation of corrective policies¹⁷

As in Japan, financial system restructuring is now going forward in the other troubled Asian countries and it appears evident that in a few years there will be many fewer banks than there are today¹⁸. Some countries, including Thailand and South Korea are acting more quickly to address problems in the financial sector than did Japan, including increased transparency, more open markets, closing down of weak institutions, more adequate capital ratios and more open accounting and disclosure rules¹⁹.

By January 1998 South Korea, Indonesia and Thailand had taken steps to restructure their banking systems²⁰. In South Korea operations of 14 out of 30 merchant banks had been suspended; two commercial banks were required to submit rehabilitation plans; impaired bank assets of some institutions have been isolated; shareholders and unsecured creditors were no longer protected when institutions closed; "liquidity" assistance had in future to be collateralized with government securities

In Indonesia 16 insolvent banks had been closed and other weak ones required to submit rehabilitation plans; "lender-of-last-resort" access was in future to have strict conditions; and state banks were to be downsized and eventually privatized.

In Thailand 58 finance companies out of 91 were suspended, with 56 to be liquidated; and "lender-of-last-resort" access was in future to have strict conditionality.

In almost all cases of emerging crises, including the one in Japan, the authorities initially took a number of steps to protect weak institutions and

¹⁷See Stanley Fisher, First Deputy Director of the International Monetary Fund, "The Asian Crisis: A View from the IMF", an Address at the Midwinter Conference of the Bankers' Association for Foreign Trade, Washington, DC, January 22, 1998.

¹⁸See "Asia Watchers Look to the Future", The Wall Street Journal, Hong Kong, as reprinted in the Globe and Mail, Toronto, July 2, 1998, p.B11.

¹⁹Michel Camdessus, Managing Director of the International Monetary Fund, "Is the Asian Crisis Over?", and Address at the National Press Club, Washington, April 2, 1998.

²⁰See "IMF Bail Outs: Truth and Fiction", International Monetary Fund, January, 1998.

weak currencies — at great cost to foreign exchange reserves and the public treasury. Yet few, if any of these attempts at rescue proved to be successful. The various authorities were unwilling, or found it very difficult, to distinguish between “liquidity” problems where “lender of last resort” assistance, both domestic and international is fully justified, and “solvency” problems where such assistance is no permanent solution and can even make matters worse if it delays the taking of appropriate corrective measures.

Emergency temporary assistance in order to reduce systemic risk by preventing panic and give time for structural reforms to become effective, including the closing of bankrupt institutions, is of course needed when crisis has erupted. The danger is that such assistance will be given without forthright introduction of the permanent structural reforms.

From all these experiences one can identify the more important structural and institutional rigidities that the Asian crisis has revealed:

- outdated exchange rate arrangements and unrealistic exchange rates
- domestic policies that shielded financial institutions from international competition
- inadequacy of financial regulatory policies and their implementation
- government support of weak financial and other corporations
- high level of government intervention in market processes
- weak regulatory regimes and inadequate information for regulators and markets
- the problem of “moral hazard” through private sector dependence on government support
- weaknesses in the balance sheets of major financial and non-financial institutions

- weakness of internal controls in financial institutions
- absence of adequate transparency and disclosure in operations and performance
- undeveloped nature of corporate governance principles and practices
- heavy dependence on short-term international capital
- close relationship between banks and large corporations and questionable loan policies

What this meant was that dealing with this new crisis, the Asian crisis, was not just a matter of restoring macroeconomic stability in the traditional sense, but also attacking the structural rigidities and institutional arrangements that were inadequate for the world that had emerged.

Furthermore, dealing with such rigidities in an unbalanced way, moving forward with some but not as quickly with others, has created additional problems for controlling the crisis. A striking example of this relates to reducing capital flow restrictions without strengthening substantially regulatory systems relating to financial institutions and organized markets²¹. An earlier example of this was the United States Savings and Loan debacle where rapid deregulation was not matched by appropriate changes in regulatory oversight or internal controls, rules of corporate governance, and effective disclosure and transparency²².

Therefore, while increased openness of markets made whole new avenues of financing possible it also increased the damage that could arise from weak regulatory regimes. Institutions had increased leeway for pursuing questionable financial practices.

The Asian crisis demonstrates again that opening up financial markets does not reduce the importance of regulation but rather changes substantially the nature of what constitutes effective regulation. It requires, among other

²¹See also Jeffrey A. Frankel, Address to the conference on "Preventing Bank Crises: Lessons from Recent Global Bank Failures", sponsored by the Federal Reserve Bank of Chicago and the World Bank, Lake Bluff, Illinois, June 11, 1997.

²²See Gerth and Stevenson, *ibid.*

things, that such regulatory systems be in harmony with the functioning of an efficient market — such as adequate transparency and disclosure, effective corporate governance, enforced codes of ethics, adequate capital ratios and strong internal risk management policies and procedures. A regulatory system that does not generate market incentives in harmony with efficiency and stability but rather attempts to hold back market forces is not likely to be effective in today's international financial environment²³.

VII. INTERNATIONAL REGULATORY SURVEILLANCE

It is somewhat surprising that a crisis as deep and widespread as the Asian crisis should emerge having in mind the substantial number of multilateral institutions and arrangements that occupy themselves in one way or another with the international financial system. I am thinking of the International Monetary Fund, the Bank for International Settlements, the World Bank, the regional development banks, the International Organization of Securities Commissions and the International Association of Insurance Supervisors.

It is true that the International Monetary Fund has had general responsibility for safeguarding the stability of the international financial system²⁴. But this had not led it over the years to develop adequate capital market expertise, to pay ongoing attention to structural problems in its members' financial systems, and to encourage raising the quality of financial system regulation. Some have even suggested that the Fund's initial intervention in the Asian crisis aggravated rather than ameliorated the flight of capital²⁵.

Typically the Fund has come into the picture after a financial crisis has erupted, providing conditional "liquidity" support and advice on macroeconomic and exchange rate policies. It is only now beginning to work with the Bank for International Settlements Committee (Basle Committee) on Banking Supervision and the World Bank in providing advice on better prudential regulation and supervision; and recently it has begun to broaden its Article IV examinations to include surveillance of the financial

²³For an excellent development of this point see Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Address to the Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, May 1, 1997.

²⁴"The IMF's Response to the Asian Crisis", International Monetary Fund, Washington, April 1998.

²⁵See Steven Radelet and Jeffrey Sachs, ibid.

sector. The World Bank has taken steps to coordinate its work in the area of the financial services sector²⁶.

The deficiencies in international surveillance of financial systems and in domestic regulatory regimes became increasingly important with the growth over the last decade of international financial markets and global financial institutions but were demonstrated beyond doubt after the collapse of the Japanese markets and of some of its financial institutions.

The Basle (BIS) Accord on risk-based capital standards for commercial banks, which were adopted by most of the industrialized countries in 1988, was a useful first step in the direction of safer domestic banking standards. But the Accord itself has weaknesses because assets of greatly varying quality can lie in the same (of four) asset baskets used to set capital ratios, and it does not address risks unrelated to capital adequacy²⁷. All this has been amply demonstrated in the Asian crisis.

These flaws in domestic and multilateral regulatory systems lie at the heart of the increased demands for more effective international regulatory oversight mechanisms, such as a super-regulator. There is increased recognition that these problems must be addressed multilaterally, as well as domestically, through ongoing coordination and cooperation among the various international financial institutions and among national regulators²⁸.

Canadian authorities have taken a leadership role in bringing this issue to the fore. The Prime Minister of Canada, The Rt. Hon. Jean Chretien, first raised this issue at the Group of Seven Heads of State or Government summit meetings in Halifax, Canada, in 1995. At the IMF Interim Committee meetings of April 1998 the Canadian Minister of Finance, the Hon. Paul Martin outlined a proposal for an international surveillance system. Its objectives are to improve domestic regulatory systems and to achieve effective coordination among the various multilateral financial

²⁶See The Honourable Paul Martin, Minister of Finance for Canada, "Statement Prepared for the Interim Committee of the International Monetary Fund", Washington, April 16, 1998.

²⁷For a good discussion of bank regulatory challenges see Laurence H. Meyer, Member, Federal Reserve Board, "Issues and Trends in Bank Regulatory Policy and Financial Modernization Legislation", Address at the Bank Administration Institute, Finance and Accounting Management Conference, Washington, DC, June 9, 1998.

²⁸See Gerth and Stevenson, *ibid.*

institutions that must be involved in maintaining international financial stability.

The Report of the G7 Finance Ministers to the G7 Heads of State or Government strongly supported the move to more effective international surveillance for improving financial system stability and this was approved by the G8 Heads of State or Government at their Birmingham Summit meeting of May 15-17, 1998.

The substantive suggestion has been made that the Asian countries in difficulty should commit themselves to the Basle Committee's "Core Principles of Effective Banking Supervision"²⁹ This suggestion is valid for all countries and their adoption has been urged by the G7 Heads of State or Government, and the G7 has also urged the development of international codes and guidelines for corporate governance and accounting principles³⁰

So the ground work is being laid for improved international surveillance of financial systems and guidance and assistance in the upgrading of regulatory systems. But realization of this objective will take considerable time and in the meantime the international financial system is riskier than it need be.

VIII. IMPACT ON CANADA OF THE ASIAN CRISIS

As was mentioned earlier Canada, so far, has been relatively immune from any contagion effect of the Asian crisis on its financial system and it is interesting to consider why this is so.

Impact through trade and investment flows: Canada clearly is feeling the balance of payments effects of the Asian crisis. It is vulnerable to economic conditions in Asia because of its trade with Asia, particularly in commodities and raw materials, and because of the flow of investments from Asia into Canada. The Asian crisis has caused a decline in their demand for Canadian exports and in addition it has been a contributing factor to the sharp drop in international commodity prices. Both have had a major impact on parts of the Canadian export industry, particularly in Western Canada. At the same

²⁹See Morris Goldstein, "The Asian Financial Crisis", Institute for International Economics, Washington, DC, March 1998.

³⁰See "G7 Chairman's Statement", May 15, 1998 .

time the high value of the Canadian dollar against the sharply depreciated Asian currencies is increasing Asian import competition in some manufacturing areas including automobiles. In the first four months of 1998 Canadian exports to Japan, South Korea, Hong Kong, Taiwan and Singapore were down 41% from a year ago and imports were up by 18%³¹.

Inflows of capital for real investment have also declined sharply and this has been felt in business and real estate investment, particularly in British Columbia and the city of Vancouver. Earlier on, when Asian capital inflows into that region were substantial, real estate prices had gone to very high levels — higher than in any other part of Canada.

An important factor softening the impact on Canada of the economic deterioration in Asia has been the floating Canadian dollar which, for reasons noted below, has declined in an orderly fashion against the US dollar.

The over-all impact on the Canadian economy of these trade and investment developments should not be exaggerated. While exports to Asia are important to Canada, they amount to only about 3% of its GDP so even a sharp decline in such exports would have only a minimal direct and indirect impact on its economy³². At present it appears as if it will reduce the 1998 real GDP growth rate by about ½% - ¾% with about the same degree of reduction for 1999. The impact on Europe and the United States appears to be of the same order of magnitude. Even a greater decline in the rate of real growth, by say 1%, while very unwelcome, would not in itself create a crisis in the Canadian economy or the Canadian financial system.

However, this assumes that such a reduction would not bring to the surface major structural weaknesses in the Canadian economy such as were brought to the surface in Asia. Therefore, a more complete examination of the Canadian economy is appropriate.

The macroeconomic policy environment: The Canadian macroeconomic policy environment had improved greatly by the time the worst of the Asian crisis erupted. The Bank of Canada and the Government of Canada have a

³¹Statistics Canada.

³²See Royal Bank of Canada Economics Department, "Economic and Financial Market Outlook 1998-99", Toronto, Spring 1998.

written agreement extending to 2001 to the effect that the goal of monetary policy will be to keep the rate of inflation between 1% and 3%. The actual rate is running close to 1%. Underlying this policy is the belief that the best contribution monetary policy can make to creating a growing economy is to protect the domestic purchasing power of the currency.

Also, the basic exchange rate policy of the Government, with the Bank of Canada as its agent for implementing policy, is to permit market forces to determine the exchange rate and to intervene in the exchange market essentially only for smoothing out short term fluctuations. In other words there have been no extended periods when the exchange rate has been viewed as artificial and so subject to major speculative attacks; or when there has been fear that exchange rate policy would undermine the policy of maintaining a low rate of inflation. Furthermore, Canada has foreign exchange reserves and access to the market for additional reserves if needed that are adequate for smoothing out shocks to its floating exchange rate; and the central bank has effective monetary control mechanisms for dealing with changing "liquidity" needs of the financial system

Not that the Bank of Canada's monetary policy has been without some controversy. Currently the Canadian dollar is at an historically low level against the US dollar, as low inflation and still substantial free labour capacity permit monetary policy to create interest rates lower than those in the United States. Some critics have accused the Bank of Canada of neglecting the Canadian dollar exchange rate. But the essential lines of monetary and exchange rate policies referred to above have not changed and return to accelerating inflation through easy monetary policy, or any move toward higher interest rates to support the dollar at the risk of deflation and weaker economic growth, is not anticipated.

A very significant change has occurred in the fiscal position of Canada. The budget of the federal government is now in balance and moving into surplus. The Asian crisis will undoubtedly reduce that surplus from what it would otherwise have been, but the essential past achievement of fiscal balance is not in jeopardy. The debate now focuses on the issue of the extent to which the future surplus should be apportioned among debt reduction, tax reduction and expenditure increases with few disputing that at least some should go to reducing the burden of outstanding debt.

As a result of Canada's much improved fiscal situation and its well understood policy of using monetary policy primarily to protect the

purchasing power value of the currency, it felt substantially fewer financial repercussions from the Asian crisis than it did from the Mexican crisis. In the latter case it experienced sharply higher risk premiums in its interest rates whereas in the case of the Asian crisis it has not³³

The fact that an essentially similar macroeconomic situation exists in the United States, which accounts for 80% of Canada's exports, was highly significant as well. But Canada has learned from past experience that a strong US economy alone is not enough to shield Canada from the harmful effects of inappropriate domestic economic policies.

Canadian financial system restructuring and regulation: As we know, fragility of the Asian financial systems has become a major part of the Asian economic crisis. The Canadian financial system does not appear to be vulnerable to "contagion", largely because it has already undergone substantial adjustments in harmony with the exigencies of global financial integration and competition.

In part this is because for more than a century the law required decennial reviews of banking and banking legislation and it permitted national banking from the beginning. This permitted both legislative and market forces to shape the financial system in an evolutionary way. In this way Canada has avoided some of the major distortions that emerged through rigid legislation in other countries such as the United States.

However, in the last two decades the forces of emerging technology and accelerating international competition have created new challenges for maintaining a stable financial system, as the Asian crisis has clearly demonstrated. In response to this the Canadian financial services regulatory regime has been under the most intensive examination over the last fifteen years, with many published studies and major regulatory changes. These have focussed on issues such as powers, capital adequacy, corporate governance and transparency.

A further intensive study as a prelude to more changes will emerge from a special Task Force in autumn of this year. Two mergers involving four of the largest Canadian banks have been announced but government approval

³³See Gordon G. Thiessen, Governor, Bank of Canada, And Address to La Conference de Montreal, May 27, 1998.

or disapproval of them awaits the outcome of the Task Force report and of succeeding parliamentary hearings. The driving force back of these mergers is the need to have increased capital bases in order to support growing financial and related activities that would otherwise drift abroad into the operations of large foreign banks; and to reduce costs further in order to meet growing international competition. Also underway is the move toward de-mutualisation of the major Canadian life insurance companies, thereby increasing their sources of capital and paving the way for greater consolidation.

Past legislative changes have led to important changes in the regulatory structure, such as the development of the Office of the Superintendent of Financial Institutions, an agency quite separate from the central bank and Department of Finance. That agency has broad powers for exercising surveillance, requesting information from regulated financial institutions, requiring changes in practices, and taking swift action when an institution is in difficulty. In addition, Canada's central bank the Bank of Canada has enjoyed substantial independence from day-to-day political forces ever since it began operations in 1935, which has protected the constancy of monetary policy.

It is now increasingly understood that moving to a more efficient and market oriented financial system does not involve getting rid of regulation but rather having regulation that is itself in harmony with the twin objectives of market efficiency and system stability³⁴. Regulation that is in disharmony with market dynamics will be constantly under attack. Therefore globalization has raised the challenge of re-regulation and not deregulation.

Not only has there been considerable focus on more effective official regulation but also there has been increasing emphasis on the importance for system stability of effective internal regulations and procedures. This development was in part in response to the failure of two small banks and some trust companies and to costly loan losses of Canadian financial institutions during the energy crisis, the LDC debt crisis and the real estate crisis of the 1970s to early 1990s. Internal controls and risk management

³⁴ Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, has outlined effectively how market forces, not regulatory changes, are shaping the financial system for greater efficiency and so the need to ensure that regulator changes designed to ensure stability do not interfere with market processes that are improving the system. See his address "Technological Change and the Design of Bank Supervisory Policies", Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, May 1, 1997.

procedures and techniques within many individual financial institutions appear to have improved considerably over the past decade.

Canadian industrial restructuring: The Canada-United States Free Trade Agreement followed by the North American Free Trade Agreement and the free trade agreement with Chile have all emerged over the last decade. It has become apparent that this move toward free trade, particularly with the United States, was of great importance not just for the development of Canada's export industries but also as an engine for restructuring virtually every sector in Canada, including the export and import competing sectors and retail trade.

The market forces unleashed by the anticipation and the reality of free trade caused most corporations in virtually every sector in Canada to adjust to the reality of increased international competition. There is no other approach to industrial restructuring that could have been as pervasive and swift as that of moving toward free trade. As a result when the Asian crisis erupted many of Canada's corporations already had behind them some years of restructuring for increased efficiency and improved international competitiveness.

The privatization of federal and provincially owned corporations has also been an important part of industrial restructuring.

Challenges ahead: As a result of all these developments and the fundamental soundness of the Canadian economy, there is little likelihood that the Canadian financial system will be in difficulty because of the Asian crisis and the macroeconomic slow down it is causing in Canada. This in turn greatly reduces the potential impact on Canada of that crisis.

All this is not to suggest that Canadian economic and regulatory policies have achieved all that it is necessary to achieve. The ratio of public debt to GDP, while declining, is still too high; the current phase of financial system restructuring is far from finished and might, for political reasons, even be delayed; the insurance and banking industries will probably see substantial consolidation over the next five years; it cannot yet be known if all financial institutions have crisis proof internal risk management practices and controls; and income tax levels in Canada are well above those in the United States, causing some talented Canadians to move there every year.

IX. IMPLICATIONS FOR LATIN AMERICA OF THE ASIAN CRISIS

The most important lesson for other countries, including Latin American countries, that emerges from the Asian crisis and its muted impact on Canada, is that its impact will be greater or smaller depending on (a) the nature of the existing macroeconomic and exchange rate situations and policies and (b) the extent to which their financial sectors and regulatory structures, and major industrial sectors, have adjusted to the reality of a huge and highly sensitive flow of private sector international capital. The worst scenario is where a country's macroeconomic situation and policy are already somewhat fragile and where its financial system and regulatory regimes have not yet undergone needed change. In that scenario loss of confidence sooner or later by international financial markets, with resulting market chaos, is a likely probability.

In this respect it is perhaps worthwhile to comment very briefly on the situation in Brazil, and even more briefly on a few other South American countries.

Brazil

Brazil introduced its macroeconomic stabilization plan in 1994, its inflation rate is down to about 3% and real growth of about 5 ½ % is possible in 1998 and 1999 if further shocks are avoided. The authorities responded quickly in October 1997 to the Asian crisis with both monetary and fiscal action, investor confidence was restored and foreign exchange reserves increased to about \$65 billion by March 1998. All this is very positive for minimizing the impact of the Asian crisis, fortunately so since Brazil's exports to Japan alone amount to about 6% and its imports about 5%³⁵.

However less positive are other aspects of the macroeconomic situation and that of the exchange rate, particularly when compared with 20 other emerging market countries. Brazil's government deficit amounts to about 5 ½ % of GDP, much higher than that of most of the other countries examined (India, Taiwan, Russia and Turkey being higher), its current account deficit is equal to just over 4% of GDP which is among the highest

³⁵See "Latin American Consensus Forecasts", Consensus Economics Inc., London, April 20, 1998.

of 21 emerging market countries (Chile, Colombia, Venezuela, Malaysia, Czech Republic are higher), its external debt exceeds three times its exports which is higher than that of 21 other developing countries except for Argentina, and its system of a managed float has produced an exchange rate that appears to be about 14% above its purchasing power parity³⁶. This means that Brazil is more vulnerable than many emerging market countries to the impacts of further international shocks and continued policy vigilance is needed to minimize them. Because of the importance of its trade with other Latin American countries, how Brazil will manage this is of considerable international importance.

The environment that emerged from the 1994 stabilization plan was incompatible with the kind of financial system that had existed in previous decades of instability. A period of government sponsored restructuring of the financial sector was introduced including mergers, liquidations, new incorporations, changes of majority ownership and strengthening of the regulatory regime. This approach of combining macroeconomic stabilization with effective structural and regulatory policies relating to the financial system seems to be working and appears to be avoiding the enormous costs of financial crises that some other countries have faced³⁷. It is apparent that a major aspect of strategy for confronting international shocks is to create a strong and competitive financial services sector.

In summary Brazil has made some progress in reducing its vulnerability to international shocks by reducing inflation and increasing interest rates and by undertaking a major restructuring of its financial system. But the remaining areas of weakness referred to here suggest that considerable more progress is needed to bring the risk of international financial shocks down permanently to comfortable proportions.

Argentina, Chile, Colombia, Venezuela

Argentina, Chile, Colombia and Venezuela all appear to have exchange rates well above their purchasing power parities, over-valued from 8% to 27%.

³⁶“Emerging Markets Monitor”, Royal Bank of Canada, Economics–Risk Management, Toronto, June 1998. The monitor includes a “Structural Risk Indicator” which suggests that of the 21 emerging countries listed, Brazil risk is exceeded only by Russia.

³⁷Jose Roberto Mendonca and Mansueto Facunda de Almeida, “Restructuring Brazil’s Financial System”, Secretariat of Economic Policy, Brazil, 1997.

This is because Argentina has its rate tied to the US dollar and the others operate managed floats. Furthermore in all cases their external debt exceeds the size of their annual exports, with Argentina's debt amounting to more than three times its exports. Apart from Venezuela they all have substantial current account deficits, ranging from 3% to 5 ½ % of GDP and apart from Chile they all have fiscal deficits, ranging from ½ % to 4% of GDP³⁸. These distortions and imbalances make them vulnerable to international shocks including any further deterioration in the Asian crisis.

In Colombia and Venezuela those distortions are also accompanied by inflation prospects for 1998 of 18% and 35% respectively while Argentina has its inflation under control and Chile also to a degree. Real GDP growth for both 1998 and 1999 appears at present to remain positive, ranging between 3% and 6%, barring further shocks.

As in Brazil, restructuring of the banking systems of these countries followed the financial crisis of 1995 which saw a number of banks collapse. We noted above that this restructuring has already involved very high fiscal outlays and it is in a sense fortunate that the restructuring was well underway by the time of the 1997 financial market chaos in Asia beginning with Thailand. It is not possible here to trace the progress of those restructuring initiatives, but the Asian experience does suggest that successful completion of those financial system reforms, including strengthened regulatory regimes, should receive high priority since they would constitute significant protection against future financial system shocks.

As for industrial restructuring, the Canadian experience suggests that the most effective and quickest way to achieve industrial restructuring is the implementation of a policy of free trade. Canada is strongly supporting the move to freer trade in Latin America, a move that will undoubtedly be the primary force for creating more internationally competitive industries in Central and South America. The MERCOSUR customs union is operational even though complete convergence will not take place until 2005, and this union will reduce production and trade distortions, help companies capture economies of scale and scope and facilitate the movement of capital to its most productive opportunities among the countries.

³⁸See "Emerging Markets Monitor", Royal Bank of Canada, *ibid.*

Just recently Canada and the Mercosur trade bloc signed a framework agreement that could lead to freer trade, either bilaterally or as a step toward the Free Trade Area of the Americas involving 34 countries that it is hoped will emerge by the year 2005³⁹. There are of course still many difficulties in achieving that objective, but the gradual process of opening up sectors to free international competition is in harmony with strategy to minimize the future impact of international shocks.

X. CONCLUSIONS: LESSONS FROM THE ASIAN CRISIS

The Asian crisis, and in some respects others that preceded it, are imparting a number of important lessons to countries addressing the problem of how best to confront international financial shocks and minimize their impact. These lessons also represent a guide to judging the extent to which a country is vulnerable to outside disturbances.

(1) Strategy to confront the Asian crisis must recognize its unique character: The Asian crisis is unique in the mix of factors underlying it. **First**, the cyclical weaknesses revealed the greatly enhanced role of international private sector capital flows and the serious consequences when managers of those flows lose confidence in the country and its institutions and corporations. **Second**, the damage done by those cyclical weaknesses are being amplified by structural weaknesses in the financial services sector and its regulation, and in other sectors as well, and by past policies that attempted to shield many of them from the forces of permanent global economic and financial integration. **Third**, there were long delays in introducing macroeconomic policies directed toward countering the slow-down in economic activity and structural policies for strengthening the financial system and its regulations. These delays have proven to be exceedingly costly.

(2) International financial shocks will not disappear after the Asian crisis:: Financial shocks, if anything, are appearing more frequently than in past decades and will continue to do so because of the permanent importance of private sector capital flows. This, together with the high costs of not taking timely action, underscores the urgency for countries to develop strategies for confronting them. The Asian experience, particularly that of Japan, suggests that this urgency has not been adequately recognized or, if

³⁹See The Globe and Mail, "Canada, Mercosur agree on framework", June 17, 1998. p.B7.

recognized, has not been reflected in action because of weak political leadership. Determined policy leadership is a prerequisite for minimizing the impact of international financial shocks.

(3) **“Contagion” is not the primary problem; domestic policy is:** The most serious cause of financial shocks is not “contagion” from other countries in difficulty but rather deficiencies in domestic macroeconomic and exchange rate policies, from domestic financial system weaknesses, from inadequate financial system regulation, and from industrial structure problems.

(4) **Latin American countries are still vulnerable:** Latin American countries continue to be vulnerable to international shocks, but not fundamentally because of the “contagion” effect from Asia. They are vulnerable because the aforementioned domestic policy prerequisites for minimizing the impact of international financial shocks are still not where they should be.

Over the last decade Canada has made substantial progress in each of those crucial policy areas, which is the principal reason why the impact on it of the Asian crisis, in spite of its strong trade and investment ties with Asia, has so far been moderate.

(5) **Problems arising from large international capital flows are permanent:** A principal reason why past domestic economic and financial structures and policies in many countries have become outdated is the volume and sensitivity of private sector international capital flows. This is a permanent and not transitory development because it has arisen through emerging computer and telecommunications technology, accompanied by advances in finance theory and the measurement of risk that have generated new and complicated financial instruments.

(6) **Retaining international confidence is key to minimizing the impact of shocks:** The importance of private international capital flows means that retaining international confidence is a prerequisite for managing international financial shocks. Therefore, the centre piece for strategy to confront international shocks must be to adjust domestic policies and structures so as to gain and retain that confidence. Furthermore, experience shows that the least cost to the economy is when this is done quickly, rather than after substantial delay.

(7) **Stabilizing macroeconomic policies are essential for limiting shock damage:** For macroeconomic policy this means achieving firm control over inflation at a low rate of price increase, an objective more likely to be achieved through central banks that are relatively independent of day-to-day politics; a level of fiscal deficits and public debt that is sustainable and consistent with directing savings to productive areas of development; and exchange rate policy that prevents the rate from getting far out of line with free market forces while yet avoiding excessive short term fluctuations.

(8) **Biggest challenge is to restructure domestic financial systems:** In some respects the newest and biggest challenge, and a vitally important one for confronting future financial crises, is to facilitate restructuring of domestic financial systems so as to greatly improve their efficiency and stability. This involves structural changes in the industry and its regulation including much more effective controls within corporations themselves. Not to pursue such policies would risk being vulnerable to future shocks and risk seeing international competitors increasing greatly their presence in domestic markets.

Specifically, this in many cases means facilitating consolidation among individual institutions; permitting financial institutions to offer a wide range of financial services; opening up markets to international competition in an orderly way in order to ensure a strongly competitive environment; introducing strong rules of corporate governance to counter fraud and questionable lending practices; requiring increased transparency in the relations between government, financial institutions and other businesses; better disclosure of operations and results so that markets can function on the basis of information rather than speculation and rumour; and improved internal procedures for measuring and controlling risk.

These actions are needed to establish and sustain international confidence in individual financial systems and institutions—a prerequisite for withstanding the shocks of international financial disturbances.

(9) **The regulatory system must be strengthened simultaneous with restructuring:** Restructuring and opening up of financial systems must be accompanied by restructuring and strengthening of their regulatory framework and policies, for to do the former and ignore or delay the latter risks the emergence of costly new problems. This has been amply demonstrated in Asia, not to mention the case of the US Savings and Loan debacle.

It is particularly important to avoid the common tendency among official authorities to underestimate the degree to which their financial systems and regulatory mechanisms are lagging the realities of market globalization and to underestimate the costs of permitting a financial crisis to develop. Timely action, it appears, is much less costly than delayed action. Because of the overwhelming presence of private capital flows, regulations must be framed so that the incentives they create are in harmony with achieving both efficient and stable financial institutions.

(10) **Regulatory systems must minimize “moral hazard”:** Evolving regulation must strike a very careful balance between achieving system stability and avoiding serious “moral hazard” problems. Dependence of financial institutions and other corporations on the “safety net” support of governments and multilateral financial institutions appears to partly explain the damaging practices that were engaged in by many institutions caught in the Asian crisis. Regulations must be framed to provide market incentives that create both efficient operations and sound institutions; they must include permitting weak and inefficient institutions to be removed from the system; and they must lead to markets having information needed for them to operate efficiently. Private financial institutions must be left feeling fully responsible for their lending and other business decisions. A significant first step is the adoption and implementation by countries of the Basle Committee’s “Core Principles of Effective Banking Supervision”.

(11) **“Liquidity” and “solvency” problems should not be confused:** Strategy for confronting international financial shocks must, of course, include effective mechanisms for dealing swiftly with temporary “liquidity” problems being experienced by solvent institutions. This is needed in order to enable normal financing to continue and to prevent panic in the system. But mechanisms for this, both domestic and international, have been in place for many years, and so do not fundamentally explain the current crisis. Nor do they, for the most part, provide answers for how to confront the current financial crisis — the latter emerging from a range of structural deficiencies that have primarily revealed cases of “insolvency”.

Of course individual country’s whose “liquidity” mechanisms are deficient must reform them because it is highly likely that they will be needed even after the Asian crisis has passed into history. In addition to supplying “liquidity” when it is needed, a swift increase in domestic interest rates when a “liquidity” crisis emerges is usually also essential, and yet one that a number of countries have been reluctant to take. The rules surrounding “lender-of-last-resort” and similar assistance should ensure that such

assistance is confined to addressing “liquidity” and not, as has often been the case, “solvency” problems⁴⁰. Experience shows that attempts to solve the latter problems with financial assistance usually lead to loss of public funds with no resolution of the crisis.

(12) Much improved international surveillance and guidance needed: Globalization has created new regulatory challenges because of the growth of global financial institutions, the volume and complexity of private sector financial flows and the impact of international competition on inefficient and poorly regulated domestic financial systems.

The Asian crisis in particular has brought to the fore the need for bringing greater multilateral focus to the challenge of financial system stability, including close and ongoing co-operation and coordination between multilateral financial institutions and between national financial regulators; and it has demonstrated beyond doubt the need for international assistance in raising the quality of domestic financial regulation. The lead Canada has taken on this issue appears to be bearing fruit, but it is much too early to determine if progress will match the urgency of the challenge.

(13) Move to free trade is the most effective mechanism for economy-wide restructuring: While the emphasis here has been on financial systems, the need for efficiency-generating industrial restructuring generally in a world of increasing international integration and competition is equally important for ensuring economic stability in the face of external shocks. Policies that attempt to shield sectors from foreign competition result in inefficient non-competitive enterprises that will not be able to survive in a world of growing global competition and free movement of capital.

The Canadian experience has been that the most powerful instrument for achieving such restructuring is an orderly but determined move toward free trade. The Canada-United States Free Trade Agreement followed by the North American Free Trade Agreement and then the free trade arrangement between Canada and Chile have led to comprehensive industrial restructuring in Canada in virtually every sector of the economy and to strong growth in exports.

⁴⁰For a comprehensive statement on the role of a central bank in dealing with a financial crisis see E. Gerald Corrigan, Chairman, International Advisors, Goldman, Sachs & Co., “How Central Banks Manage Financial Crises”, An Address, Shanghai, October 25, 1995.

COMENTARIOS

David Blanco, Presidente de la Asociación de Bancos e Instituciones Financieras (ASOBAN).

Voy a dividir mi exposición en tres partes: la naturaleza de la crisis; las manifestaciones de la crisis asiática en los sistemas bancarios de América Latina y finalmente, algunos comentarios sobre la solidez del sistema bancario boliviano, del sistema financiero y su situación ante la entrada de nuevas instituciones en este proceso financiero y de desarrollo que está viviendo el país.

La naturaleza de la crisis que estamos viviendo es una crisis de larga duración y no de corto plazo. Es similar a la que se observó con el “efecto tequila” en México; a las crisis bancarias que se dieron en algunos países de Latinoamérica; incluso a la crisis de fines de los años 70 que se tradujo en aumentos de los precios del petróleo. Es más, representa un tipo de crisis similar a la de los años 80 con el tema de la deuda externa de los países subdesarrollados. Sin embargo, la gran diferencia del contexto actual está en los flujos de capital que son el principal vehículo de transmisión de los shocks financieros, distinguiendo básicamente dos situaciones: aquellas derivadas de problemas de liquidez y aquellas derivadas de problemas de solvencia.

Recordemos también que otros elementos que caracterizan las crisis no solamente están relacionados con las políticas macroeconómicas que adoptan los países, sino también con el manejo de sus políticas cambiarias y con la existencia o no, de sistemas financieros regulados, estables y sólidos en el tiempo.

En países como Canadá, con políticas macroeconómicas estables, inflación anual de 1%, inexistencia de déficit fiscal, etc., todo su sistema de regulación interno les ha tomado quince años en construirlo. Evidentemente, el impacto de crisis de esta naturaleza se reflejará esencialmente en una disminución de las exportaciones de ese país.

Pero volvamos a las crisis. En tales casos, la experiencia nos muestra la utilización de cuatro prácticas: financiamientos de corto plazo; mayor coordinación entre los bancos centrales; utilización de los bancos centrales como prestamistas de última instancia y aumentos de la liquidez del sistema

económico utilizando acuerdos internacionales, por ejemplo, del Grupo de los Siete cuando Europa tuvo problemas.

Finalmente, en Bolivia hemos tenido crisis en el sistema bancario en estos últimos dos o tres años. Personalmente, creo que un logro muy importante en la prevención de crisis es que a partir de junio de este año, ningún banquero, ningún ejecutivo bancario puede obtener créditos en los bancos que administra o que posee. Hemos avanzado mucho en el tema de créditos vinculados.

Otro tema muy importante en Bolivia es, valga la expresión, movernos hacia Basilea que básicamente significa medir la situación patrimonial de un banco en función de la calidad de sus activos de riesgo. En ese sentido no me preocupa tanto el sistema bancario boliviano porque está entrando en una etapa de transición productiva para el país. Sin embargo, es preocupante que en el país existan más de cien organizaciones no gubernamentales (ONGs) que intermedian recursos financieros bajo diferentes modalidades en el campo y en la ciudad, aparte de otros intermediarios que necesariamente tendrán que ser incorporados al sistema de regulación.

Es claro que al entrar bancos extranjeros al país, con mayor o menor participación de capital, van a tener que haber mecanismos de coordinación mucho más claros entre bancos centrales, entre superintendencias y obviamente, de acuerdo con los mecanismos de Basilea.

Jorge Torres, Presidente de la Comisión de Descentralización y Participación Popular de la Cámara de Diputados.

Mis comentarios van a girar en torno a los tres puntos identificados por el Dr. Neufeld como de carácter estratégico y al mismo tiempo genérico para enfrentar shocks financieros internacionales. Obviamente, mi análisis estará sesgado por mi ubicación en el Poder Legislativo; por lo tanto, haré mayor énfasis en aspectos de carácter normativo y regulatorio.

Los tres puntos definidos por el Dr. Neufeld como estratégicos fueron: disponer de mecanismos rápidos de acción, internos e internacionales; la existencia de un ambiente macroeconómico y tipo de cambio estables y, finalmente, contar con un adecuado marco regulatorio y normativo del sistema financiero.

Creo que la confianza de los inversionistas dependerá de cómo ellos perciben el estado de desarrollo en que se encuentran esos tres elementos cuando se produzcan este tipo de remezones. Su decisión afectará la dirección de los flujos -entrada o salida- de capitales de un país.

En nuestro caso habría que decir que todavía no nos hemos visto afectados por los diferentes shocks, al menos directa o inmediatamente, debido a la incipiente apertura de nuestro mercado de capitales a los flujos externos. Por el momento, el grado de apertura de nuestro mercado es bajo y eso ha brindado una especie de protección natural frente a ese tipo de shocks. Sin embargo, el país está adoptando medidas para cambiar esta situación que también modificará dicho mecanismo de protección natural.

En este momento estamos en una etapa en que queremos ganar la confianza de los inversionistas, estamos atrayendo algunos capitales. Una vez que éstos lleguen, el reto será mantenerlos, hacer que no se pierdan. Precisamente en ese contexto, quiero referirme a un instrumento fundamental para enfrentar este tipo de shocks en el futuro.

Como es conocido, el país ya tomó una serie de iniciativas positivas para consolidar las instituciones o los actores institucionales directamente relacionados con el sistema financiero: Banco Central de Bolivia, la Superintendencia de Bancos y otras instituciones; es decir, se han hecho esfuerzos por asegurar su independencia, por garantizar la estabilidad del mandato de sus autoridades y obviamente por preservar la continuidad de sus políticas y acciones.

Sin embargo, creo que además era necesario pasar de un enfoque de carácter sectorial hacia uno de carácter intrasectorial. Precisamente, la Ley de Propiedad y Crédito Popular y concretamente el CONFIP, es el instrumento que apunta a ello, permitiéndonos que vayamos avanzando gradualmente, preparándonos mejor para la apertura de Bolivia hacia los flujos de capitales.

Un aspecto que debe destacarse es que este instrumento, el CONFIP, es fruto de la concertación y consenso entre los actuales actores institucionales: el Banco Central y la Superintendencia de Bancos, para tratar de maximizar la coordinación entre ambos.

El CONFIP está diseñado para ser un instrumento “desburocratizado” en el que participarán las propias superintendencias, que posteriormente tendrán que ejecutar las normas aprobadas por ese cuerpo colegiado.

Una característica en nuestros países es aquella relativa a las dificultades que tienen los Congresos para responder oportunamente a las necesidades de actualización de normas legales, tendiendo por ello, a la aprobación de leyes marco. Sin embargo, la aprobación de leyes marco requiere la seguridad de que la instancia que posteriormente las vaya a reglamentar, tenga la suficiente capacidad y solvencia para hacerlo. Por ejemplo, ahora el Congreso está preparando el proyecto de ley de entidades no bancarias que posteriormente será reglamentado por el CONFIP, de tal manera que vaya a quedar “soldado” a la actual Ley de Bancos.

Precisamente el espíritu de las futuras normas marco está dado en un artículo de la ley que establece que las autoridades competentes quedan facultadas para autorizar las nuevas operaciones y licencias solicitadas con restricciones o limitaciones operativas, en función a la capacidad administrativa, operativa, desempeño y responsabilidad de la entidad solicitante.

No me extiendo más. Simplemente reitero que el país al haber dado estos pasos hacia adelante, está preparándose para enfrentar de mejor manera eventuales shocks futuros.