Creating a Viable Global Financial System

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What were the Sources of Failure? Borrowing Too Much, Short-Term and in Wrong Currency

- Excessive Leverage
- Moral Hazard
- Maturity Mismatch
- Currency Mismatch
- Vulnerability to Speculative Attacks

Reduction of Excessive Leverage

- Highly leverage firms are more likely to fail than firms with low leverage
- High leverage greatly increases the odds of moral hazard
- High leverage also increases the odds of systemic failure because of domino and spillover effects
- A lower debt/equity ratio reduces the domino effect of insolvency and bankruptcy--no borrower will become too big to fail
- Excessive leverage can be discouraged by the central bank charging a commercial bank a deposit insurance premium that is calibrated to the debt/equity ratio of the borrowers of the bank. This gives the banks the incentive to lend to borrowers with lower debt/equity ratios

Excessive Leverage Should be Discouraged/Prevented

- Globalization of accounting standards and disclosure (transparency) requirements
  - Insistence of financially responsible auditors by lenders
- Global credit reporting system for large borrowers (say over $500 million in aggregate debt) (e.g., LTCM, Daewoo)
  - Voluntary reporting by lenders of large credit transactions of large borrowers (say, transactions exceeding $500 million each) to a central bureau operated by a consortium of global lenders
  - Inquiry by lenders of total cumulative debt to-date (as opposed to debts to individual lenders, thus preserving confidentiality and privacy) prior to extension of additional credit
  - It is in the self-interest of each lender to cooperate and to report to such a system
  - Regulatory agencies may require that a lender must have knowledge of the total outstanding indebtedness of its large borrowers prior to extension of additional credit

Reduction of Moral hazard on the Parts of Both Lenders and Borrowers

- Past bailouts (Latin American loans, Mexican loans) of developed country lenders encourage moral hazard on the part of lenders
- Implicit guarantee of banks and enterprises “too big to fail” by governments encourage moral hazard on the part of borrowers

Maturity and Currency Mismatch

- Maturity mismatch--borrowing short and investing (lending) long
- Currency mismatch--revenue and cost (liability) in different currencies
  - Vulnerability magnified by high debt to equity ratio
  - Insolvency caused directly or indirectly by declines in the exchange rates
  - Oversold currencies create unnecessary bankruptcies and discourage re-capitalization and re-structuring

The Hazards of Short-Term Foreign Capital

- Over-dependence on foreign capital, especially short-term foreign capital, makes an economy and its exchange rate vulnerable
- Foreign direct investment is better than foreign portfolio investment or loans because it is less mobile
- Long-term loans is better than short-term loans because they are not subject to immediate withdrawal
- Short-term foreign-currency denominated loans should be carefully monitored and controlled in order to avoid the compounding of currency mismatch by maturity mismatch
- Short-term foreign funds are inherently different from short-term domestic funds because the former is much more likely to leave at the first sign of real or imagined trouble

Reducing Dependence on Short-Term Foreign Capital

- Lengthening maturities of foreign-currency denominated loans through the imposition of a fee by the central bank, say, of 25 basis points, each time such a loan is made or renewed. This fee implies the recognition by the central bank of such a loan, which should be comforting to the foreign lenders. However, it also has the effect of forcing the foreign lenders and the domestic borrowers to rethink whether a foreign-currency loan is in their best interests and if so whether a longer-term loan, with floating rates of interest, may fit their interests better, reducing the potential fees payable to the central bank
- Larger reserve requirements can also be imposed on non-resident domestic currency deposits on the grounds that they are likely to be more mobile than resident domestic currency deposits

Reducing Dependence on Short-Term Foreign Capital

- Foreign portfolio investment can be channel into closed-end mutual funds and/or foreign depository receipts, greatly reducing the potential impact of a massive sell-off by foreign portfolio investors on the exchange rate
- Foreign direct investment should be promoted as a substitute to foreign portfolio investment (Many East Asian countries, such as South Korea and Thailand, used to discourage foreign direct investment, especially in some selected industries.)

Reducing Vulnerability to Speculation: An Adequate Level of Foreign Exchange Reserves

- An adequate level of foreign exchange reserves should be maintained, taking into account not only trade flows but also short-term and long-term capital flows. A conservative estimate of foreign-currency needs would be three months of imports plus the stock of foreign portfolio investment plus the stock of short-term foreign-currency denominated bank loans plus debt service on long-term foreign-currency denominated debt. If foreign exchange reserves, plus available lines from international organizations and other counties, are perceived to be less than the estimated foreign currency needs, a run on foreign currency may ensue.

Monitoring Predatory Speculation

- Predatory speculation by hedge funds should be monitored and controlled --through mandatory disclosure of large positions and imposition of margin requirements on purely speculative (non-current account-related) transactions reducing the degree of leverage and hence potential profitability

A Rule-Based Lender of Last Resort: A Cooperative Asian Currency Stabilization Fund

- A multi-country cooperative currency stabilization fund may have a useful role to play by augmenting the potential foreign exchange reserves perceived to be available for the defense of any single currency. (Timely intervention in the currency markets of certain countries, such as Indonesia, would have helped to reduce the misery significantly.)
- In order to avoid moral hazard, countries must meet certain prescribed rules of solvency and liquidity in order to avail themselves of the facility