CURRENT WORLD FINANCIAL CRISES: LESSONS TO BE LEARNT

By
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Abstract

Turmoil in international financial markets has generated widespread instability in recent times, visiting calamity on millions of people across the globe. Although financial crises had occurred for as long as there have been financial markets, the crises in the emerging countries in the late 1990s and in 2000/2002 were global and potentially more damaging to economic and political stability than the crises of the past. The crises that hit Latin America in the 1980s were significantly different from those of the 1990s and 2000/2002. The paper traces the causes of the previous financial crises and dwells extensively on the on-going crises in Argentina and the Enron debacle of the U.S. It outlines the lessons from the past crises and proposes ways that countries could reduce the risk of financial crisis to include: avoiding an overvalued currency by allowing the currency's value to float; maintaining a substantial level of foreign exchange reserves; keeping short term foreign exchange liabilities low relative to reserves; maintaining a sound banking system; and a coordinated global approach to supervision and auditing of financial institutions, to stem contagion problems.

1. INTRODUCTION

The late 1980s and the 1990s witnessed a very substantial expansion of the global capital market, with rapid increases in private debt and equity flows and in foreign direct investment. This expansion reflected a wide variety of changes in the global political environment, in financial technology, and in investors' preferences. The collapse of the Soviet Union and the general shift to more democratic and market-oriented policies around the world increased the attractiveness of lending and investing in emerging market economies and the desire by their governments to attract foreign equity capital. Technological developments facilitated global portfolio management and retail indexes funds that shifted debt and equity funds to emerging economies. Investors pursued the opportunity to diversify their portfolio for the higher returns and the lower overall volatility that they believed would follow such diversification.

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Although financial crises have occurred for as long as there have been financial markets, the crises in the emerging countries in the late 1990s and in 2000 and 2001 were global and potentially more damaging to economic and political stability than the crises of the past. Thus, finding ways to reduce the risk of future crises and to improve the management of crises when they occur is paramount. In order to avoid the mistakes of the past, there is need to carefully study the causes of the recent crises so as to situate and locate the appropriate lessons that could forestall future crises.

Turmoil in international markets has generated widespread instability in recent times, visiting calamity on millions of people across the globe. Not only have financial crises been frequent in number worldwide, but they have also often been extremely costly in terms of both declines in real output and increased transfer payments from tax payers to bank depositors and other financial claimants whose funds were explicitly and implicitly insured or guaranteed at par value by the government. Thus, financial crises are a major policy concern the world over. The IMF estimates that cumulative losses in gross domestic product (GPD) from potential growth in 158 currency crises in 53 countries between 1980 and 1995 averaged 4.3 per cent of the trend GDP values in each country and 7.1 per cent in 96 crises in which most output losses were suffered (IMF, 1998). The magnitude and size of these crises and the fact that many of them occur concurrently across countries and give rise to widespread fear of contagion or systemic risk clearly explain why financial crises attract the attention of bankers, policy makers, and political leaders worldwide.

However, the causes, characteristics, dangers and other features of these crises are not usually delineated and analysed. Indeed, most analyses have focused on the implications for the developed world and the relatively advanced emerging economies. There is paucity of analysis relating to the West African Sub-region. Although the experience in each country that witnessed crisis was unique, certain common factors contributed in varying degrees to the crises. What then are the lessons to be learned from this experience? What can be done to reduce the risk of recurrent crises? This paper seeks to discuss the current world financial crises, dwelling extensively on the on-going financial crises in Argentina and the Enron debacle of the USA. The overriding aim is to draw relevant lessons for the West African sub-region.

The remaining part of the paper is arranged thus: Part II presents a brief background review of previous financial crises. Part II dwells on theoretical issues and review of literature while Part IV outlines some issues arising from the on-going crisis in Argentina as well as the Enron debacle of the U.S. In Part V the lessons and challenges are discussed. Part VI presents the conclusion.

2.
REVIEW OF PREVIOUS CRISES

The crises that hit Latin America in the 1980s were significantly different from those of the 1990s and 2000/2001. The governments of some Latin American countries had borrowed heavily from commercial banks during the 1970s, encouraged by very low real interest rates and high prices for their commodity exports. Thus, when real interest rates rose markedly at the end of that decade and an American recession reduced the demand for Latin American exports the borrower-countries were unable to service their debts. As a result, the major money centre banks in the US and Europe were significantly impaired, causing widespread concern about the possibility of a systemic banking crisis in the industrial economies. Latin American governments were forced to reduce their spending that was financed by foreign credits. In addition, the economies of those counties were deflated in order to increase net exports so that they could make interest and principal payments on their external debts. However, a general recovery of global demand coupled with decline in real interest rates as well as induced write-down of debt eventually brought the crisis under control.

The Latin American governments financed their subsequent budget deficits in their domestic capital markets to a much greater extent while the commercial banks of the industrial countries reduced their lending to foreign governments. Although large current account deficits continued in several countries, they were financed primarily by a combination of private borrowing in international bond markets, equity flows and foreign direct investment.

Structural weaknesses in some of the economies were evident. In many cases, exceptionally high investment rates concealed inefficiencies in the allocation of investment funds in the economy. Investment plans were often undertaken without reference to realistic assessment or measurement of expected rates of return. The financial and solvency position of many large investing companies was also seriously over-stated by inaccurate accounting procedures. Many financial crises have often been preceded by sharp and speculative rises in real and financial asset prices. Such sharp and unsustainable rise in asset prices has a bearing on subsequent financial distress through several channels but principally through the effect on the demand and supply of bank credit.

Many of the crisis-countries have had a long tradition of substantial government involvement and ownership in the banking system. This meant that funds were often channeled to ailing industries under overt and covert political pressure. In effect, banks were not acting as market-oriented financial intermediaries but as channels for the public support of industries that would not have received that much support through market mechanisms.

Some elements of bad banking have played a major role in the emergence of financial crises. Basically these practices were concealed during the optimism generated by the previous period of rapid economic growth. The weaknesses included:

- Banks operating on the basis of low capital ratios which were sometimes below minimum levels required by the regulatory authorities but which did not enforce them.

- Substantial foreign currency exposures which were incurred because foreign currency borrowing was cheap, the commitment to a fixed exchange rate was not questioned, and because of the general expectation of bail-out in the event of difficulty.

- Very rapid growth in bank lending.

- Weak risk analysis and management systems within banks.

- Excessively concentrated portfolios, often with a substantial exposure to the property and real estate sector either directly in the form of loans or indirectly through the collateral offered by borrowers.

- Bank lending on the basis of an unsustainable rise in asset prices.

- Substantial connected lending by banks to companies within the same group and on the basis of poor risk assessment and non-market criteria.

- The failure to incorporate risk premia in the interest rate on loans. The BIS (1998) noted that in many crisis-countries, the lending margin was low (and was declining during the period of rapid growth) relative to operating costs which showed that insufficient risk premia were being charged.

- Inadequate accounting standards and weak loan classification and provisioning which had the effect of over-stating the value of bank loans and thus the true capital position of banks.

With the benefit of hindsight, it is clear that the crises of the 1990s and 2000/2001 were due to a combination of unsustainable current account deficits, excessive short-term foreign debts, and weak domestic banking systems. On the whole, policy instability and structural macroeconomic weaknesses exacerbated by poor risk analysis by banks, weak internal credit control systems, connected lending, insufficient capital, ineffective regulation, monitoring and supervision by the regulatory agencies and weak internal governance systems have been identified as the main causes of the current crises. As observed by Lindgren et

al (1996), banking crises are a complex interactive mix of economic, financial and structural weaknesses.

3.
THEORETICAL FRAMEWORK

A convenient point of departure for the discussion in this section is to attempt to identify and situate the distinguishing features of different types of crises. The literature basically identifies two types of crises: Currency crises and financial crises. While the former involve a sudden movement of the exchange rate and sharp change in capital flows, the latter usually originate in or induce insolvency in the banking system, and feature a collapse in asset prices, most often in equity and securities markets.

Demirguc-Kunt and Detragiache (1997) observe that banking system insolvency has various manifestations, such as a run on banks, large bail-out programmes or nationalization. It also manifests in the form of large non-performing loans.

However, the above categorization requires a high sense of judgement to determine the type of crises a country is in, since it is not clear what constitutes a 'sudden' move of exchange rate, a sharp change in capital flows, and when a bank run is systemic, or merely represents a flow of deposits from weak banks to strong ones.

Financial crisis usually involves a corporate debt problem in the non-bank financial sector. Put differently, banks and other intermediaries usually do not get into trouble if borrowers can easily service their debt. Financial crises can occur without any currency crisis as exemplified in some African countries. It should also be noted that the crises in Africa, where no bank runs were involved, arose from the insolvency of the banking system. Crises have triggering events or shocks. A banking crisis is generally ignited either by the insolvency of one or more large banks or similar financial institutions or by widespread depositor runs on large banks or similar financial institutions perceived to be insolvent and unable to meet their deposit liabilities or other debt claims as and when due and at par value. A currency crisis is generally started either by a sharp, substantial, and disorderly decline in the exchange rate in one country, often from levels set by a fixed (pegged) or crawling peg exchange rate regime, or by a speculative run on a country's currency exchange rate (E. Chengreen, et el, 1996).

Consequently, banking and currency crises both involve an actual or potential depreciation in the value of financial claims. This reflects a failure by banks or countries on a fixed or near-fixed exchange rate system to keep their promise to redeem or exchange, respectively, claims at a given rate. For banks and other privately owned financial institutions, this

results in insolvency and either restructuring or liquidation. For the affected countries, although they survive, they are likely to experience losses from higher foreign debt burdens and from economic and socio-political turmoil and subsequent defaults and restructuring of debt.

Currency and banking crises are mutually reinforcing, particularly in fixed or semi-fixed exchange rate regimes. Banking crises may also ignite currency crisis particularly in smaller, open economies on fixed or semi-fixed exchange rate systems. If the banking and any accompanying macroeconomic and asset price bubble problems are sufficiently severe, domestic and foreign depositors at insolvent or near-insolvent banks are likely to shift their deposits to perceived safer banks, including foreign-owned domestically or non-domestically domiciled banks, and possibly in foreign-currency denominated deposits. The likelihood of such behaviour is high, if as the crisis increases in magnitude, doubts arise about the government's ability or commitment to maintain full deposit guarantees. At the same time, other domestic and foreign investors are likely to shift their funds abroad; such capital outflows exert an upward pressure on the country's exchange rate. If the country attempts to protect its exchange rate by drawing down on its reserves, aggregate bank reserves are reduced by the same amount. Unless offset by increases through other central bank activities, those sales intensify the banking and macroeconomic problems by forcing further bank asset sales and monetary contraction and aiding further capital outflows. This makes it more compelling for countries to devalue their currencies.

Currency crises, characterized by a sharp depreciation in exchange rates, are likely to increase both the burden of debt denominated in foreign currency to domestic borrowers and the probability of default on such debt. The former will reduce the profitability of domestic debtor firms and even threaten their solvency. The latter is likely to reduce capital inflows, especially in the short run. Both effects will exert a downward pressure on aggregate income. Likewise, a sharp depreciation in the currency of one country relative to its trading partners will increase the price of its imports and thereby its rate of inflation. In the short run, the exchange rate will stimulate exports. These effects are likely to reduce the exports both of the country's trading partners and of its export competitors to third countries and may set off one or more rounds of competitive depreciation, possibly accompanied by increased trade and capital barriers. Thus, aggregate income in all affected countries will be reduced.

On the other hand, a currency crisis can trigger off banking crisis. If a country experiencing a speculative run on its currency attempts to protect its exchange rate from depreciating by selling foreign currency, the resulting reduction in its international reserves will reduce bank reserves, and unless offset by the central bank, ignite a multiple contraction in money and credit that could threaten the solvency of banks. However, to avoid, or at least delay, the depreciation arising from a speculative run, a country usually increases its interest rate to

discourage additional capital outflows and attract capital inflows. The higher rates dampen domestic economic activity, increase loan defaults, and threaten bank solvency. Speculative runs on a currency are also likely to induce runs from domestic currency deposits to foreign currency deposits even with the same bank. This is a run on domestic currency not on banks, but with time might provoke a run on banks. If a country does not prevent successive depreciations and if accompanying declines in aggregate income are sufficiently large, loan defaults are likely to increase and could drive some banks into insolvency. Loan defaults are likely to be more frequent and larger if bank and/or banks customers have borrowed in foreign currencies on an un-hedged basis and were forced by the depreciation to make larger domestic currency payments than expected. Thus, even banks that fully hedge their foreign currency borrowing by foreign currency loans to domestic borrowers are likely to suffer defaults when the domestic currency depreciates markedly.

Detragiache et al (1997, 1998) examined the determinants of financial crises using multivariate logic analysis of the likelihood of a baking crisis, based on indicators such as: Macro (GDP growth, changes in terms of trade, real interest rate, inflation, depreciation of the exchange rate, and government surplus/GDP; financial (M2, Foreign exchange reserves, credit growth/GDP, bank cash/bank assets, and private credit/GDP; and institutional indicators (GDP per capita, the presence or absence of explicit deposit insurance, and an index of law and order, which is a proxy for the ability to enforce contracts).

The model explained about 70 percent of the crises that occurred, and within sample only predicted a crisis when none occurred in 15 per cent of the cases. However, in the study, exchange rates or the terms of trade variables were not significant in most specifications. It should, however, be noted that their sample period stopped in 1994 which technically excluded the Mexican and Asian crises. The result indicated that slower output growth; increases in real interest rates; deposit insurance; poor legal systems; and low per capita GDP were associated with high likelihood of banking crises.

Recent research on the causes of financial crises have focused almost exclusively on the Asian crises. This is very instructive, because the countries, Thailand, Indonesia and Korea (usually listed among the Tigers) had for several decades experienced rapid growth of real incomes and living standards, and all appeared to have relatively favourable macroeconomic indicators, including low inflation, fiscal balance or surpluses, and exceptionally high savings rates.

Krungman (1998) examines the links between moral hazard and over investment. He notes that implicit guarantees that governments would stand behind financial intermediaries led to investment based not on expected return but on close links between the government and the owner/managers of intermediaries. McKinnon and Pill (1998) underscore the opposite side of the relationship, over-borrowing, which occurs when the non-bank private sector

becomes triumphalist about the success of reform because of the overly optimistic implicit signal about macroeconomic developments contained in loose credit decisions.

Indeed, excessively high leverage, a reliance on short-term debt, and property market bubbles were the main features in the East Asian crises. Private credit grew significantly in excess of GDP throughout the 1990s. However, as Corsetti, et al (1998) observe, this explanation is more relevant for Thailand than either Korea or Indonesia. In Korea, for instance, debt–equity ratios had been excessive for some time, making it difficult to track a period of demonstrably excessive growth. The real exchange rate appreciation of their currencies encouraged a sharp increase in investment in non-traded goods, especially construction. It became obvious by 1997 that new office space in Bangkok and Jakarta, whose capacity had reached about 8 times the level in the early 1990s, was a misallocation of resources. In retrospect, it appears the property boom had collapsed well in advance of any foreign exchange panic, as property indexes on the stock exchange by end-1996 were about one third lower than their levels in 1993.

Radelet and Sachs (1998) on the Asian crises, maintain that the panic by foreign investors caused the crises, but given the warning signs of the problems in the financial sector, including the declining property market, it is more likely that the panic merely exacerbated the underlying problem. In their contribution, Corsetti et al (1998) note that the crisis occurred because investors became aware of the fundamental problems of banking and corporate debt.

A novel contribution by Burnside et al (1998) features a model in which a currency crisis could be caused by foreigners awakening to the fiscal costs of the financial sector crisis for, even if stated fiscal positions are in balance or surplus, the actual positions, when there are large contingent liabilities of the banking sector, can be in large deficit. This approach accepts the possibility of self-fulfilling crises. If the market decides that banks are weak and there is a run on the currency, banks with direct or indirect foreign exchange exposure can be rendered insolvent. Consequently a panic by investors might be rational or irrational.

On the policy front, Stiglitz (1998) underscores the role played by premature financial sector liberalization, especially where existing institutions, regulation, and supervision and other parts of the infrastructure that would support incentive-compatible behaviour are absent. Thus, the need for sequencing of financial reforms is emphasized by this viewpoint.

4.
CURRENT WORLD FINANCIAL CRISES

(a)
Argentine Crisis

In order to understand the current financial crisis in Argentina, it would be useful to review the macroeconomic developments in the country during the last decade. In the early 1990s, the government of Argentina undertook a series of important reforms in policy, including monetary policy, fiscal policy, structural policy, and international trade policy. A highly inflationary monetary policy was replaced by a new ***convertibility law***, which pegged the peso at par to the dollar and largely prevented the central bank from financing the government's budget deficit by printing money.

Fiscal policy was also brought under control with a decline in deficits. On the structural side, a comprehensive privatization programme was implemented and a number of inefficient state-owned enterprises were privatized. Furthermore, barriers to international trade and investment were reduced and Argentina's financial sector was opened to foreign investors.

These reforms produced very impressive results. Inflation was drastically reduced from over 3000 per cent to single digit through the convertibility law. Economic growth turned around sharply, with GDP growth averaging 4 per cent per annum in the early 1990s owing to the rapid growth in exports. The sharp increase in economic growth was even more remarkable given the very rapid disinflation that occurred at the time. However; by late 1990s, there were a number of policy setbacks and external shocks, which sharply reduced the economic growth in Argentina and ultimately led to the financial crisis in 2000 – 2001, and the current decline in overall economic activity.

First, government budget deficits began to increase which indicated that discipline had begun to wane. With government spending increasing faster than tax revenues, the central government budget deficit rose to an average of 2 percent of GDP a year in the late 1990s from 1 percent in early 1990s. In addition to increased spending by the central government, other factors also put pressure on the budget: federal revenue-sharing arrangement with the provinces provided little incentive to contain costs, and tax compliance remained very low. These deficits could not be financed by money creation because of the convertibility law. Instead, borrowing in both domestic and international capital markets financed them. However, as government's debt began to rise, questions about sustainability of debt were being raised, risk premia rose, resulting in increased interest rates. Eventually, the higher interest rates put additional pressure on the budget and held back economic growth.

Second, the low inflation of the early 1990s turned into persistent deflation, which also had negative effects on economic growth. The currencies of Argentina's major trading partners in Europe and Brazil depreciated relative to the US dollar and, therefore, relative to the Argentine peso. This effective appreciation of the peso and consequent deterioration in Argentina's competitiveness, along with higher interest rates, further constrained economic growth.

Third, persistent expectations of depreciation of the peso caused interest rates on peso loans to be higher than those on dollar-denominated loans. In addition, whenever policy actions were taken that raised questions about central bank independence or about the convertibility law, market expectations of depreciation increased, causing domestic interest rates to rise further. For instance, the replacement of the Governor of the Central Bank and the adjustment of the convertibility law to allow for a basket of euros and dollars unsettled the market somewhat.

As low economic growth persisted into 2000, concerns began to grow that a vicious cycle of low tax revenues and continued increased government spending would lead to rising interest rates, which would further slow the economy. Following the political turmoil in October 2000 when Vice President Alvarez resigned, Argentina's borrowing costs soared and rolling over government debt became more and more difficult. Renewed plans to reduce the budget deficit brought interest rates down temporarily, but by February 2001 it was clear that further actions needed to be taken. In March 2001, a newly appointed Economy Minister, Lopez Murphy, announced significant reductions in government spending. But after strong political protests, Cavallo replaced him as Economy Minister in the summer of 2002 and began to introduce a number of policy changes which culminated in a Zero-deficit law.

Eventually, however, it became obvious that these changes to the budget were not working. The government debt was becoming unsustainable in the view of many market participants, and interest rates on government debt began to increase sharply. By October, it was clear that debt would have to be restructured and, indeed, President de la Rua announced the debt restructuring intention of government.

As the restructuring effort was underway, the uncertainty about its impact on the banking system led to increasingly large deposit withdrawals from banks and international reserves began to decline. In order to halt the withdrawals and the decline in reserves, the government imposed severe restrictions on such withdrawals in December. Soon after the restrictions were imposed, social and political protests turned violent, leading to the resignation of President de la Rue and his ministers.

Economic circumstances in Argentina have deteriorated even more rapidly since the imposition of the restrictions on deposit withdrawals. The lack of a functioning payments system has led to a virtual halt to most economic activities. The shortage of liquidity is hindering economic activity and underlines much of the social frustration. The Duhalde government, which took over in January 2002, is in the process of gradually removing these restrictions and, at the same time, adopting a flexible exchange-rate system.

During this period, the government of Argentina had several programmes with the Fund. In March 2000, Argentina obtained a $7.4 billion IMF programme. The government, however, treated the programme as "precautionary", meaning that the government did not intend to draw on it. As noted earlier, by summer of 2000, there was growing concern in financial markets that the persistent recession could lead to financial crisis.

In December 2000 Argentina drew $2.0 billion from its IMF Programme. In the succeeding month, the IMF approved an additional $6.3 billion for Argentina's programme, bringing the total programme size to $13.7 billion. The Argentine government agreed to a series of deeper structural measures in the areas of fiscal, pension and health-care reforms to help develop a sustainable fiscal position in the medium term and to rebuild investor confidence, in a programme with the IMF signed in January, 2001.

The January 2001 supplementary programme was designed to allow the Argentine government time to work on its structural reform agenda and to meet relatively relaxed fiscal deficit targets in the first half of the year. However, Argentina missed its first-quarter fiscal targets and second-quarter structural reform benchmarks.

In August 2001, the IMF provided Argentina with an additional $8 billion. The U.S government supported the designation of part of the IMF package with $3.0 billion, essentially to be used to support a voluntary, market-based debt operation. However, when the tax revenues continued to plummet and the government failed to reach an agreement to downsize transfers to the provinces, it became increasingly apparent that the government was not going to be able to meet its fiscal targets and had no other sources of financing. This fuelled concerns about the government's ability to service its debt, particularly to domestic banks, and eventually induced an accelerated run on the banking system.

In December 2001, the IMF acknowledged that Argentina was not going to meet its fiscal targets for the fourth quarter that were agreed in August and that its programme was no longer sustainable. Thus, the Fund could not complete its review and consequently did not disburse a loan tranche in December 2001.

b)
The Enron Crisis

The case of Enron is particularly interesting, although Enron is not a financial institution. Enron, a Houston-based energy firm, founded by Kenneth Lay, transformed itself over its 16 years lifespan from an obscure gas-pipeline concern to the world's largest energy- trading company. Encouraged by deregulation, the company turned to electricity to supply its natural gas business. Its attempted entry into California's retail electricity market in 2001 was unsuccessful. In the same year, the company's decade-long involvement in DAHOL, an Indian power-plant project, also ran into deep waters. Lack of transparency undermined Enron's credibility, and in October 2001, its shares and credit rating plummeted considerably. In November 2001, Dyney, a rival firm, backed out of a proposed lifeline merger after Enron's debt was downgraded to junk status. Enron filed for bankruptcy in December 2001. Currently, Enron's accountants, Andersen, which destroyed papers related to ENRON, is under investigation for negligent auditing; Enron's bankers are also facing scrutiny.

A growing body of evidence suggests that Enron was a peculiarly egregious case of bad management, misleading accounts, shoddy auditing and, quite probably, outright fraud. The involvement of a reputable accounting firm like Andersen in shredding of incriminating documents just ahead of investigation was very unprofessional and, indeed, it is a smear on the accounting profession.

The leading issue in the Enron case is the role and responsibility of Auditors in a failed institution. There is need to revaluate the accounting standards in our countries. One way of guaranteering transparency is the adoption of the IMF Code of good practices in governance and financial matters by our governments, the private sector and the civil society, including the accounting and auditing firms. Furthermore, the appointment of auditors should be approved by a government agency on the recommendation of the private firm concerned.

5.
LESSONS FROM THE VARIOUS CRISES

What lessons may be gleaned from our review of the large number of banking and currency crises worldwide in recent times. The major lesson appears to be that there are no silver bullets or easy answers to either preventing such crises or solving them quickly at no or low cost after they have developed. Although countries experiencing either of both crises have many similarities and the perpetrators can generally be identified after the event, nearly all crises differ in significant ways and perpetrators are often difficult, if not impossible, to

identify ahead of time. Nevertheless, the following lessons from the recent crises for both corporate and public policies may be highlighted.

(i)
Information and Incentive Problems

Correcting information and incentive problems appears to be a principal lesson to learn by the national authorities. Preliminary evidence has shown that those economies with the most conservative regulatory environment had best-weathered the crises. Although improving information should be a clear goal, authorities need to realize that they will never eliminate information asymmetries or financial crises. Given the nature of information problems, having bank surveillance by "multiple eyes" is a recommended approach, meaning that owners, markets, and supervisors all need to be given clear incentives and information to monitor banks.

Merely increasing capital ratios in the hope that it would induce better bank performance may not be an effective solution: the quality of bank capital ratios could induce more risk-taking (see Berger et al, 1995). In Argentina for instance, the required capital ratio most clearly is a function of risk being taken; banks are required to have higher minimum ratios the lower their individual CAMEL rating, and the more they lend in excess of 200 basis points above prime rate, and the greater the market risks they undertake. In addition, with the requirement that banks issue sub-ordinated debt, there is now the ability to use both market and supervisory input in making decisions as to their risk.

Moving to forward-looking risk models as a way of ensuring better behaviour among bankers should be effective but only if significant penalties are assessed when bankers violate the assumptions of their risk models. Making sure that there are some uninsured debt holders in the market will help with monitoring from this source. Above all, public disclosure and peer review of financial and management information of public companies will go a long way in stemming failure arising from deliberate manipulation of facts.

(ii)
Safety Nets

To the extent that the regulatory authorities raise the cost or limit the coverage of the safety net for banking, fewer banking crises might be expected. However, with a more limited or more expensive safety net, the non-bank industry will grow rapidly; this has been the case in Argentina in the last eighteen months, in part, to escape such costs. However, as experience in Thailand has shown, non-bank finance company problems can infect the banking sector, and a cardinal rule of financial regulation should be that all institutions that take deposits and make loans should be regulated as banks. The challenge facing the government will be to ensure that financial intermediation wherever it occurs, is well regulated.

Within the framework of an improved and transparent regulatory environment, government can more assuredly expect that financial intermediation will be more likely to absorb, rather than magnify, shocks.

In recent years, the IMF has responded to crises with increasingly large financing packages, leading to concerns that some private creditors were acting on the assumption that their investment would be protected whenever there was financial crisis. This approach has been guided by the view that it is neither feasible nor desirable for official sector resources to grow at the rate necessary to ensure that all creditors in all cases would always be able to get paid in full.

(iii)
Differentiation between Countries and Markets

Another lesson is that investors are increasingly differentiating between countries and markets based on fundamental economic assessments. Such judgment is aided by better information. The observed differentiation is reducing contagion from one country to another, as exemplified most recently by the relative stability in other emerging markets over the past few months despite the crises in Argentina. Concern over the risk of contagion by the official sector in the past led to the expectation on the part of investors in emerging markets that the official sector would bail them out. That encouraged excessive risk taking and gave rise to the very conditions that made financial crises more likely.

(iv)
Creditworthiness and Solvency

Another important lesson is that policies allowing firms to rebuild their credit worthiness quickly will at the same time contribute to a prompt recovery of the overall economy. The emphasis on credit worthiness also suggests that a policy of allowing insolvent banks to fail runs the risk of reducing firms' ability to borrow, thereby prolonging a slump. If banks must be shut, there should be an effort to preserve their monitoring expertise on the relevant industries. Moreover, to the extent that the government has to spend resources on restructuring after a spate of bankruptcies, it should avoid raising taxes in a slump since that would further limit borrowing capacity of the entrepreneurial class and further slow recovery.

We have learned that fragile banking systems can act as powerful amplifiers of external shocks. And because domestic banks are an important interface between the international financial system and the domestic economy, the banking system is particularly exposed to international financial turbulence. When the banking system is fragile, an economic or financial shock can lead to a loss of confidence in the system's stability, which can generate a disruptive flight from the banking system. A robust banking system is thus built on three pillars: **Solvency, Liquidity and Confidence.**

Solvency of the banking system is a valid concern because the volatile macroeconomic environment in which our banks operate creates major shocks to the profitability of bank borrowers, and, therefore, the quality of bank portfolios. Here, it is worth noting that banks do not benefit when their borrowers experience a positive shock, because for the most part, they make loans rather than equity investment but banks do lose when their borrowers experience an adverse shock large enough to result in defaults. However, solvency can also be threatened by good times, such as when a surge of capital inflows is intermediated by banks, creating a lending boom that results in impaired balance sheets and a vulnerable financial system.

Ensuring that banks remain solvent is more difficult in the Sub-region because supervisors work with a weaker information base, and the scarcity of relevant skills undermines the effectiveness of bank regulation and supervision. To ensure that banks are solvent and that solvency is sustained, the authorities should:

- Impose significantly, higher capital adequacy standards than may be appropriate for banks located in the industrial economies. In this connection, it should be noted that the 8 percent capital adequacy ratio that was enshrined in the Basel Accord was designed for major, internationally active banks operating in the advanced economies. Banks operating in other regions with uncertainly need more capital. For instance, in Argentina, owing to the observed high-volatility environment, the ratio was raised to 11 percent, recently.

- Institute mechanisms to promote market discipline of domestic banks. Market discipline is not a cure-all but in an environment with limited information availability, it is particularly useful to complement official supervision with the efforts of informed investors who have a financial stake in the soundness of banks. In this regard, the requirement is some countries that a significant portion of a domestic bank's capital be in the form of sub-ordinated debt is particularly instructive. This structure creates a set of informed investors who have an incentive to monitor the behaviour of banks in which they are investing, thus complementing the efforts of the official regulatory authorities.

- Internationalise the domestic banking system. Banking firms are national not because national borders define natural market limits, but simply because bank charters are granted by national authorities, so that they can regulate the activities that take place within the country's borders. Internationally active banks promote robustness because they are diversified geographically, which makes them less vulnerable to country-specific macroeconomic and financial shocks. When they are hit by such shocks, local branches or subsidiaries of major international banks have access to the parent company's stock of capital. Furthermore, international banks from well supervised financial systems with well functioning capital markets bring with them the supervisory impact of

word-class regulators and the market discipline imposed by the world's most demanding capital markets.

However, solvency is a necessary but not sufficient condition for protecting the domestic financial system. This is because banks are primarily vulnerable to liquidity crises, generated by runs, by bank depositors, or by reserve outflows associated with an interruption of international capital flows during a temporary breakdown of the international financial system. Liquidity shortages caused by these events may force banks to promptly and unexpectedly contract credit, putting both their borrowers and the economy under strain, and eventually undermining the stability of the financial system. The risks of systemic illiquidity in the banking system are more real and far more difficult to handle in a relatively underdeveloped financial system like ours. The authorities can deal with this problem by:

- Including bank liquidity requirements as an essential element of the prudential regulatory framework, whether they are needed for the purpose of monetary control or not. Where the volatility of demand for bank deposits is high, liquidity requirements should also be high. And to prevent these requirements from unnecessarily raising the cost of credit, they should be remunerated. A substantial portion of the reserves should be in the form of liquid foreign currency assets that can satisfy the sudden demand for international liquidity in the event of a shock.

- Discourage intermediation of short-term capital inflow by requiring that banks hold substantial reserves against all of their short-term liabilities, foreign and domestic. If international deposits are more volatile than domestic, they should attract higher reserve requirements.

Solvency and liquidity are essential elements, but they may not be enough, for even the most prudently run bank could be brought down by a bank-run. Thus, the domestic banking system needs to inspire confidence. To promote confidence in the domestic banks, the authorities should:

- Promote transparency by setting high standards for bank disclosure and working with the private sector to improve accounting standards. There should be interface between supervision and auditing.

- Create adequate safety nets so that small depositors will be assured of the safety of their deposits, and will therefore be less reluctant to flee on the basis of vague anxieties or rumours. Admittedly, such safety nets create potential problems of moral hazard, which must be controlled through the prudential regulatory and supervisory framework. However, the costs of such moral hazard are usually overstated, and even at that, are small compared to the cost of a bank-run that would have been prevented.

6.
CONCLUSION

A major lesson emerging from the above discussion on financial crises is that they may well be an integral part of the development process in economies that are both at an intermediate level of financial development and in the process of liberalizing their capital flows. This is a clear warning that we should not view these emerging market economies as being beyond redemption . Calls to undertake hasty and radical overhauling of the economic system should thus be moderated and guarded. We have also seen that unrestricted financial liberalization may actually destabilize an economy and bring about crises that would not have happened otherwise. If a major crisis is likely to be costly in the long run, fully liberalizing foreign capital flows and fully opening up the economy to foreign lending may not be a good idea at least until the domestic financial sector is adequately developed. This, however, is not the case if only FDI is liberalized.

There are four primary ways in which a country can reduce the risk of a currency crisis: One, avoiding an overvalued currency by allowing the currency to float. Two, maintaining a substantial level of foreign exchange reserves. Three, keeping short-term foreign exchange liabilities low relative to reserves. Four, maintaining a sound banking system. Although these policies can in principle avoid the fundamental factors that caused the crises of the 1980s and 1990s and event of 2000/2001 and discourage purely speculative attacks, crises will no doubt continue to occur in the future. The fact that the crises of the 1990s were caused by different conditions from those that led to the crises of the 1980s should, in itself, be a warning that factors that we do not anticipate may cause crises in the future. What countries can do to protect themselves is to avoid the policies that caused crises in the past. In this connection, it should be noted that factors common to all the crises are the problems of corruption and moral hazard. If crises do occur, the consequences for the economy will depend on how they are managed and the structural conditions within the economy at the time of the crises.

The lessons are of general applicability and could be useful, particularly now that the countries in the West African Sub-region are working towards a unified monetary system and a common currency. There is, therefore, a need to build appropriate safeguards into the current framework being designed to ensure that financial crises are contained and that they do not develop into systemic problems. Indeed, the ability of the countries to weather the storm of previous financial crises in our sub-region was not necessarily due to sound financial management, but essentially because the financial systems were not much internationalized and integrated into the global economy. However, with a monetary union, internationalisation becomes imperative, calling for appropriate safeguards against contagion arising from international financial market volatility.

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