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CREATOR: Nouriel Roubini ( CN=Nouriel Roubini/OU=CEA/O=EOP [ CEA ] )

CREATION DATE/TIME:28-AUG-1998 12:18:18.00

SUBJECT: Re: WB paper on restructuring. URGENT

TO: Matthew R. McBrady ( CN=Matthew R. McBrady/OU=CEA/O=EOP @ EOP [ CEA ] )

READ:UNKNOWN

TEXT:

Matt, I received the attached paper from a world bank economist working on restructuring in Asia. Read the parts on corporate restructuring and lets discuss it this afternoon, say 3.00pm.

The paper in in Word format (available on our desktops in the alternative applications window).

Nouriel

----- Forwarded by Nouriel Roubini/CEA/EOP on 08/28/98  
12:15 PM -----

Cclaessens @ worldbank.org

08/28/98 11:34:52 AM

Record Type: Record

To: Nouriel Roubini/CEA/EOP

cc:

Subject: Re:

As promised.

(See attached file: paper on bank and corporate restructuring.doc)

Stijn Claessens, The World Bank, Room MC 10-627, 1818 H Street, N.W.,  
Washington, D.C. 20433, USA. EM cclaessens@worldbank.org, Fax 202  
522-2031, Tel 202 473-7212

- paper on bank and corporate restructuring.doc

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

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ank and Corporate Restructuring:  
Experiences and Lessons for East Asia

## Executive Summary

{To be done}

### 1. Introduction

#### Nature and dimensions of the crisis

Corporate sectors in most East Asian countries have been very adversely affected by economic downturns since the crisis broke, with more than half of firms in the five affected East Asian countries not being able to fully service their liabilities. The distress of highly leveraged firms has been triggered by drops in asset values (stocks, real estate especially), sharp rises in liabilities, particularly due to unhedged foreign exposures and high domestic interest rates, and large declines in aggregate demand. Debt service obligations have sharply risen due to the combination of high interest rates and steep currency devaluations. Revenues have declined due to the slowdown in domestic demand and low export demand, while costs have gone up, leading to a squeeze on margins. The net result is a large reduction in creditworthiness of most firms and outright insolvency of many. For example, in Indonesia two-thirds of the corporates are estimated to have significant debt-servicing problems this year.

#### The balance sheets of banks

Balance sheets of banks have sustained similarly large shocks. In addition to unhedged foreign and interest exposures, banks have suffered from sharply worsening credit risk of their borrowers. Higher provisioning requirements have hurt income. Faced with tighter prudential guidelines, weakened financial positions and large uncertainty, banks have become more risk averse. Banks have preferred to hold relatively safe government securities and other assets, reducing credit available to enterprises. Weakened aggregate demand and financial position of firms, has made lending less attractive, even if banks were as willing to lend as previously. Lending has also been constricted by the closure of insolvent financial institutions, which has disrupted lender-borrower relationships.

#### Domestic demand

Domestic demand both private consumption and investment has collapsed in all the affected countries and has not been offset by larger public expenditures, which are increasingly claimed by funding requirements in the banking sector. The expectation was that export demand would pick up substantially after the major devaluations; so far, exports have not increased much in value terms. Data show that even in the major export industries, firms are operating at lower capacity and with fewer workers than last year. The current account adjustment has been massive, mainly through a sharp reduction in imports, and has been much more rapid than expected. The regional nature of the crisis has contributed to the vicious nature of the crisis.

Systemic restructuring efforts are needed. Governments have been undertaking reform programs aimed at enhancing the environment for facilitating corporate and banking system restructuring. The systemic nature of the problems, however, means that these efforts are unlikely sufficient: experience from other countries with equally large or even smaller problems, sug

gests that enhanced efforts are necessary to avoid a protracted period of uncertainty, limited lending, and slow economic growth. An overall, comprehensive approach to resolving financial sector and corporate sector difficulties, which involves an active role of the government in terms of analysis, providing fiscal resources, adopting the necessary legal and regulatory measures and setting the overall framework is therefore required. Recognizing this, specific systemic bank and corporate restructuring plans are being considered in several East Asian countries, with other countries likely having to face this soon as well.

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ith multiple, and sometimes competing goals. These programs include both short-run and long run objectives. The former include reversing the vicious circle of collapsing aggregate demand, loss of confidence in the financial system, and corporate sector credit crunch, revitalizing the financial sector, initiating financial and corporate sector restructuring consistent with macroeconomic recovery, and providing a macroeconomic stimulus. The latter include a strengthening of the financial sector through enhanced governance, increased efficiency and competition, market-based protection of the financial system, a strengthening of the corporate sector through enhanced governance, increased competitiveness, reduction of debt/equity ratios, and the further development of securities markets. The challenge for policy makers is to coordinate all elements in a way that maintains the pressure on all parties concerned to carry out the restructuring of the corporate and financial sector in a way that: (i) minimizes the cost to the taxpayer; (ii) leads to competitive real and financial sector; and (iii) minimizes the chance of recurrence of a crisis.

In the short-run, restoring financial

confidence has been paramount to limit the flight of capital and disintermediation from the financial system. The restoration of credit flows, to allow for a restoration of working capital to viable enterprises, and the prevention of the continued financing of unviable enterprises, and the resumption of growth has been a second imperative. In the financial sector restoring relatively sound banks and other financial institutions to health has been a related objective. To allow for a sustainable financial sector, the separation of viable from unviable corporates, and achieving the operational changes at the individual corporate level, have to get underway. From a medium-term point of view, solutions in the corporate sector require fundamental changes in corporate governance and corporate financing structures and dealing with the issues of poor transparency, limited role of minority shareholders in governance, and large, concentrated family control. This should aim to achieve systemic changes in corporate financing, including a more balanced corporate financing structure with lower debt-equity ratios, more reliance on capital markets and improved corporate governance, including a greater role for outside investors. The medium-term restructuring of financial systems requires the operational restructuring of sound banks, resolution of non-viable financial institutions, and the privatization of banks nationalized in the process of financial sector restructuring. And distressed assets acquired by government will need to be resolved.

Altogether, a

very complex undertaking. This is a complex problem, raising many issues:

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inks with macro-economy: the financial restructuring depends importantly on the speed at which macro-stability (interest rates and exchange rate) can be achieved

ed, as this will determine the viability of firms and financial institutions. Reduced uncertainty is also necessary to make an adequate assessment of the viability of firms. Yet, achieving macro stability will require some degree of progress in financial and corporate restructuring.

Institutional constraints: the

limited institutional development in East Asia, particular in the area of resolution of financial institutions and reorganization of corporates, complicates the separation of viable from unviable firms. Yet, putting in place the legal, regulatory, tax and most importantly the institutional and human capacity will take some time.

Sequencing: financial and corporate restructuring have obvious

links: good firms are necessary for good banks; at the same time, corporate restructuring will require some bank restructuring. Initiating one of the two too premature may create risks, e.g., early bank recapitalization may create (further) moral hazard and undermine any operational restructuring at the corporate level.

Short-term versus long-term: not all short-run interventions further

long-term strengthening of financial systems and corporate governance. To achieve financial stability, for example, guarantees on financial institutions liabilities may be attractive; yet these increase moral hazard and limit the degree of freedom in dealing with financial distress.

Political economy: political and

social constraints are likely to prove important obstacles to rapid financial reform. Restructuring involves allocation of large losses and redistribution of wealth and control, directly through restructuring of assets and liabilities and indirectly through taxation and wage and employment adjustments. Countries will need to go through an extensive social and political decision process to make these difficult choices.

Leading to questions of design. The design of these programs raises thus a number of questions:

Which mechanisms are most successful

in restarting and enhancing credit flows in the short-run?

What is the

sequencing of bank and corporate restructuring and who should be the lead agent of change: ex-ante bank recapitalization, and let the banks work out the loans, or ex-post bank recapitalization, after the corporate restructuring is sufficiently far underway?

What mechanisms can be used in the large task to separate the viable from unviable corporates and banks?

Which short-run measures best

support the necessary long-run changes in the financial sector and corporate financing and corporate governance?

What role do governments need to play in

systemic restructuring? Should, for example, distressed assets be managed centrally under government mandate or be left to manage by private institutions, and the government only provide resources?

How can capital assistance measures to

banks and corporates by the government be made most supportive of private sector efforts in strengthening capital? What degree of burden sharing is necessary and can be expected from existing shareholders? Might this burden sharing differ between corporates and financial institutions?

Should distressed assets be seg



regulated or not? If so, is keeping non-performing assets within a bank a good model, or are more centrally managed means of managing assets more appropriate?

The issue of systemic bank and corporate restructuring is not only a key issue for East Asia, but has also been (and is likely to be in the future) an issue in other developing countries. Experiences from other countries, including systemic restructuring in Eastern Europe, Latin America, and Scandinavian countries and elsewhere, show that there are no unique, first-best solution. Systemic restructuring programs are difficult to design and have often led to moral hazard problems. Careful design taking into account country-specific conditions is imperative, as is the concurrent pursuit of appropriate macro-economic policies, including the provision of adequate external liquidity, and the development of supporting institutions and processes. Critical in the medium-term will be building the social and political consensus necessary to carry the programs through. Systemic restructuring after all involves the allocation of losses, and redistribution of wealth and control. The key question in the end, who will pay for the cost, government, shareholders of banks and corporates, foreign investors, will inevitably be a political and social issue.

## 2. Sources of banking and corporate distress in East Asia

Structural weaknesses of the corporate sector. The recent financial crisis in East Asia has exposed weaknesses in its corporate sectors and in the link between the corporate and financial sectors (see further World Bank, 1998a and Claessens et al., 1998). In recent years, East Asian corporates compared to other developing or developed countries were characterized by higher leverage with lower profitability. Corporates in Thailand and Korea, for example, had very high level of leverage 340 percent and 620 percent on average in 1997, respectively. Leverage increased further very rapidly in the years preceding the crisis (see chart). Between 1991 and 1996, leverage doubled for Thailand and Malaysia, and increased by one-third for Korea. As a result of incomplete reporting (notable on off-shore borrowings and activities of key affiliates) and flexible accounting practices, Korean chaebols are even more indebted than these figures suggest, with the common practice of intra-chaebol equity ownership and cross-guaranteeing the bank debt of chaebol affiliates further adding to leverage.

The fast increase in debt was often accompanied by slow growth in earnings. In Thailand, for example, return on assets sharply declined, from 8 percent in 1991 to 1 percent in 1996. Return on assets was also declining since 1991 for Indonesia, Philippines, and Korea. Value added generated by the corporate sector (operating earnings before interest and wages) was on a declining terms in many countries. Higher leverage was correlated with worse performance, suggesting that banks and other outside investors did a poor job at monitoring management of corporates. This set the stage for the 1997 crisis among East Asian corporates and resulting impact on East Asian financial systems.

Charts on (changes in) leverage, profitability, value added and relationship between the two.

Structural weaknesses of the financial sector. Banking systems in many East Asian countries have been characterized by poor governa

nce and management, inadequate control of risks, and in recent years by low profitability and capital (see World Bank, 1998a and Claessens and Glaessner, 1997). As in many other developing countries, bank operations in many East Asian countries lacked disclosure and transparency. Boards of directors of banks exerted little control over management, and in some countries, notably Korea, were even in recent years influenced significantly by government. Most banks had very limited internal interest and exchange rate management systems. The crisis has also brought to light that many banks borrowed in foreign currency and had substantial unhedged foreign exchange exposures, either directly or indirectly as their borrowers did not have foreign exchange earnings from which to service their foreign exchange obligations. Most important weakness in the East Asian banking systems was the limited institutional development of banks and banks did not utilize modern credit risk management techniques. Much of the lending, for example, was done on a collateral basis, rather than on a cash-flow basis, thus obfuscating the need to analyze the profitability and riskiness of the underlying projects. Credit tended to flow to borrowers with relationships to bank owners and to favored sectors, rather than on the basis of projected cash flows, realistic sensitivity analysis and recoverable collateral values.

#### Previous corporate

debt restructurings involved often little more than extraordinarily long-term grace periods on principal and interest, suggesting that substantial asset quality problem likely existed prior to the current crisis. Non-bank financial institutions (NBFIs—finance companies, merchant banks, investment and trust companies, securities firms, leasing companies, life insurance companies, etc.) exhibited many of these same weaknesses. In addition, many NBFIs were controlled by corporates, notably the large chaebols in Korea, which in some cases has led to financing on non-market terms. In general, NBFIs were often weakly supervised and funded many of the risky investments, notably real estate.

#### And of

East Asian capital markets. Contributing factor was the limited development of bond and other securities markets: these markets lacked sufficient depth and breadth, discipline, regulatory effectiveness, and good quality institutional players to be a reliable source of funds, and the lack thereof contributed to the crisis (see box). Better-developed capital markets could have helped monitor corporates behavior, provide longer maturities and diversified some of the risks that now piled up in the banking system. The design of tax system and enforcement thereof and other regulations also contributed to the bias towards debt financing. And the desire of close control over corporates made bank-lending more attractive than bond financing, with its more stringent disclosure requirements.

**Box:** Contribution of limited East Asian capital market development to the crisis.

In analyzing the limitations of the Asian markets, a useful distinction can be made between the active and passive role of capital markets. East Asia's economic development was based on intermediation of high savings by banks to businesses. This bank debt was supplemented by excessive short-term foreign borrowings. The channeling of household savings by banks to corporates led to a highly leveraged financial structure, with high ratios of bank liabilities to GDP. The markets lack of depth contributed to the lack of corporate discipline of the kind that a good capital market could exert on enterprises. These innate limitations of the financing structure amplified the magnitude of the corporate

e vulnerability, and lead to the crisis. Bond markets were characterized by inadequate supply of issues in terms of volume, and standardization, and lack of liquidity in the secondary market; trading and providers of liquidity are predominantly security houses with insufficient capital; very limited institutional investors; a short term bias of investors and inefficient or non-existent channels for securities distribution. Government bond markets were virtually nonexistent, illiquid, and bond market development was hampered by lack of benchmarks and yield curves.

Deficiencies in an active monitoring and allocative capacity were also evident. Institutional weaknesses in the capital markets led to a lack of monitoring of corporates in the buildup to the crisis and therefore misallocation of resources, and ensuing lack of discipline of investments. The key foundations that ensure the success of capital markets—transparency, corporate accountability and governance, and proper risk pricing via the transmission of market signals—were lacking, and therefore led to poor corporate practices in Asia.

The lack of research and credit analysis and rating capacity led to poor allocative efficiency of financial resources and contributed to the crisis.

#### Reflection

Reflecting underlying institutional weaknesses. That these perverse relationships could take place is a revelation of important deficiencies in the regulatory framework and governance of both the financial and corporate sectors. The financial system in East Asia provided an implicit protection to poorly performing firms by continuing to provide them with loans. This was the result of weak banks, a result in turn of the poor incentive framework under which the banks operated. Besides the weak role of owners in disciplining banks management, particularly for state-owned banks, the legal and regulatory framework was inadequate. Weaknesses of the operating environment for banks included: inadequately designed and weakly enforced lending limits; asset classification systems and provisioning rules for possible losses which fell far short of international standards; and no exit policy for troubled financial institutions.

#### Several countries had

extensive gaps in their regulatory, supervisory, accounting, auditing, and disclosure frameworks. For example, the General Banking Act of the Philippines did not require commercial banks to maintain risk-adjusted capital adequacy ratios, and the central bank calculated these ratios for its universal banks on a shadow basis. In Thailand the rules for classifying assets allowed loans to be in non-accrual for twelve months before being classified as non-performing. As a result non-performing loans were underreported by several factors. In many countries information about commercial banks exposure in such key areas as real estate was often unreliable or outdated, exacerbating the volatility of asset prices because economic participants overreacted to news or events. The lack of transparent and adequate information in Thailand meant that there was little early warning prior to July 1997 for investors about the extent of the problems. And supervision, that is the enforcement of these regulations, was a weak spot in most East Asian countries.

And an unholy trinity. The links between bank, corporates and government were large in East Asia, leading to perverse connections between lenders and borrowers and inefficient intermediation of resources.

The nature of these linkages differed between the affected East Asian countries. In Korea and some other countries, the state historically played a large role in setting interest rates for loans and determining the allocation of resources.

nces, whether directly (through state and development banks) or by guiding the decisions of commercial banks. In addition to state-directed lending, family and other relationship lending has been important in other countries. In Indonesia and Thailand, for example, many of the same families or economic groups that control banks are also owners of major corporates, with adverse implications for the allocation of resources and assumption of risks. The insiders cum poor resource allocation phenomenon is corroborated by the fact that the most rapid increases in leverage occurred for those firms which had tighter ownership links with financial institutions and the worst profitability. And the degree of concentrated ownership and control of the corporate sector is itself an explanatory factor across nine East Asian countries of the occurrence and depth of the financial crisis.

Misguided financial liberalization with inadequate supervision often played into this unholy trinity. In Korea, for example, offshore borrowings by merchant banks, often controlled by chaebols, was liberalized. At the same time, foreign direct investment and portfolio flows were restricted (as were long-term foreign exchange borrowings by corporates). As a result, chaebols, through the merchant banks they controlled, rapidly built up their short-term foreign exchange claims, while maintaining competitive advantages over foreign investment in their domestic market. In other East Asian countries, foreign exchange borrowings increased the most for corporates with concentrated ownership structures?

Which are typical of other financial crises. Many of the characteristics of the East Asia financial crisis mirror a pattern that has become familiar over the years. Complacency leading to excessive exposure to exchange risk following a period of stability was also a feature of the Southern cone crises of Argentina, Chile and Uruguay in 1979-83, and of Mexico in 1994-5, for example. Even in the absence of currency stability large nominal interest rate differentials have induced such exposure, for example in Turkey, 1994. A credit-driven boom-and-bust cycle in real estate and equities was already documented in the 1920s and 30s in many developed countries, and was also a distinctive characteristic of many industrial country crises since the 1970s including the Nordic Countries 1987-94 and Japan since 1992. Misguided financial liberalization played a role in many financial crises (Demirgüç-Kunt and Detragiache, 1998).

Banking crises have also seen their fair share of management deficiencies. Sometimes these were based on poor judgement or myopia, especially following financial liberalizations that exposed bankers to unfamiliar risks (problems in Estonia and Lithuania in the early 1990s provide examples). In other cases, managerial deficiencies were more culpable, as in cases of excessive exposure to bank shareholders, directors or other related parties or other forms of insider dealing, recklessness and fraud. While these managerial deficiencies need not be related to macroeconomic downturns, an unrelated macro shock has often been the trigger that transformed hidden insolvency into open failure.

Many other developing and transition countries displayed a recurrent or endemic pattern of distress with insolvency and illiquidity (usually traceable to pervasive government involvement) persisting for years. Here the financial system was often a sort of quasi-fiscal entity making loans at the behest of central or regional government (or prominent politicians) regardless of creditworthiness, an



d implicitly relying on government to make up the resulting deficiency in due course with some form of subsidy or by allowing the bank or bankers' cartel monopoly profits on other lines of business. In a sense, the widespread banking problems inherited by transition economies can be seen as an example of this phenomenon. Here again a deteriorating macro situation has not been the cause of the crisis, and need not even have been the trigger that brought it to light.

With deep causes. The causes and symptoms of East Asia's crisis, especially the microeconomic and institutional weaknesses, are thus typical of financial crises. Caprio and Klingebiel, 1996 for example, find that of the 86 episodes of bank insolvency (1980-94) in their dataset, at least 20 of these featured cronyism, meaning excessive political interference, connected lending, or similar labels; at least 30 featured overborrowing; panics by foreign investors played a role in Latin American crises of the 1980s and in East Asia in the 1990s; and premature liberalization could be cited in virtually all cases. Of course, macroeconomic factors are common in bank insolvency, especially terms of trade declines or recessions, but in general multiple factors were featured in most financial crises.

Table from Caprio/Klingebiel, 1996, on the typical sources of the crisis.

But, causes run deeper than this variety of proximate factors, although they contribute to the explanation. Crises are typically manifestations of deeper characteristics of the financial sector related to information and incentive problems. Caprio (1998), for example, presents evidence suggesting that those economies with the most conservative regulatory environment, i.e., those which encouraged greater disclosure and had a more limited safety-net, have more likely avoided or better weathered crises, either coming from within their own country or a result of global spillovers. Resolving these deeper weaknesses is a more complex and more time-consuming problem.

(Chart from Caprio, 1998, with scores of regulatory environment and changes in interest rates).

### 3. Progress to date in East Asia and the short-run agenda

Restructuring of financial systems in East Asia has started. Since the onset of their financial crises, East Asian countries have taken some steps to restructure their financial sectors (see further World Bank, 1998a). Countries have closed or merged a number of commercial banks, finance companies, and merchant banks. Processes have been initiated for dealing with insolvent financial institutions and reviewing the capital position of remaining financial institutions. In a few countries, government programs have been put in place for enticing new capital infusions from existing or new shareholders. Stakes in some financial institutions have been sold to foreign investors, and a few financial institutions have attracted some new capital. Governments have assisted financial institutions by taking over distressed loans, including through creating agencies acquiring non-performing assets, and have provided other types of balance sheet support.

As is often in financial crises, countries have also limited their options for dealing with distress.



ssed financial institutions. In attempts to restore confidence among investors in the initial phases of the crisis, several East Asian governments have issued formal guarantees on deposits and creditors, and in some cases, on the external debt incurred by financial institutions and corporates. These government guarantees limit the degree to which private creditors of financial institutions can be asked to share the burden of financial restructuring. With these guarantees now in place, governments have de-facto become the owners of many insolvent financial institutions.

And of the corporate sector. Market-based approaches to corporate restructuring have also been initiated. These approaches include, among others: operational restructuring leading to higher efficiency and profitability; foreign inflows for new investments; asset sales to foreigners and domestic residents; offshore and domestic equity issuance; and debt restructuring. Most of these approaches are currently being used on a case-by-case basis in East Asian countries. Governments have also undertaken some steps to enhance the enabling environment to make these measures more attainable and efficient. Furthermore, governments have facilitated the further development of capital markets, to allow for additional sources of outside capital.

But these are hindered by many factors. These efforts are nevertheless hindered by many factors. In addition to a financial crisis, countries have had to deal with the related issues of foreign exchange crises, trying to achieve macro-stabilization, which comes with higher interest rates and fiscal stress, along with a general economic contraction of a regional nature. Especially complicating have been institutional deficiencies, many of which had contributed to the crisis in the first place. These importantly include the weak institutional frameworks for bank and corporate restructuring and resolution, including liquidation of corporates and closures of financial institutions.

Box: suspend or not: lessons from Indonesia, Thailand and Korea: SFO?

As a result, the process of closing individual, insolvent financial institutions has mostly negatively affected the overall confidence in the financial system (see also Kaminsky and Schmukler, 1998). Closure in Thailand and Indonesia of financial institutions that were completely insolvent and in particularly bad financial condition, for example, rather than instilling fresh confidence in the banking system, caused panic. This has included withdrawals of deposits from most private national banks to state and locally-based foreign banks and other financial instruments, including the movement of savings off-shore (see box). Such spillovers occurred because of an inadequate institutional framework for dealing with insolvent financial institutions. Corporate workout mechanisms in the region including skills in restructuring, the legal infrastructure and court systems are typically poor, relatively inefficient, and untested.

And unlikely to be sufficient. Further pursuing these market-based, flow approaches would limit the burden on taxpayers, reduce the likelihood that governments end up as primary owner of productive resources, and may help to deepen capital markets. However while the exact magnitude and speed can be debated most estimates suggest that for most East Asian countries actions outlined above are not likely to lead to a quick resolution of the crisis and

d robust corporate and financial systems.

On the corporate sector side, there is a general lack of equity, domestic or foreign, in the next few years to allow a reduction in corporate debt to sustainable levels, i.e., debt/equity ratios will remain high. Analysis for Korea, for example, suggests that the flow-only solution will result in an average debt/equity ratio of the largest chaebols of still more than 400% in the year 2000. While Korean firms have traditionally had high debt-equity ratios, this 400% ratio is above historical levels and much above that common in market economies. Similar analysis applies to other East Asian countries. Private sector estimates (e.g., Jardine Fleming) show that at the largest 20 firms Thai firms alone require US\$23bn (or 205% of the aggregate market capitalization), Indonesian firms \$19bn (or 196%), and Philippine firm US\$3.5bn (or 22%) to de-leverage to a debt-equity ratio of 50%, the ratio prevalent in most developed countries. While this de-leveraging can be achieved in various ways—asset sales, debt-for-equity swaps, debt forgiveness, and new equity mobilization—it is unlikely sufficient.

Furthermore, with the general uncertain financial and economic environment, this high debt burden leaves corporations very much exposed to shocks. The large corporate distress also implies that flow solutions will not unlikely be sufficient to restore solvency for many firms. In the affected East Asian countries, X% of firms listed on stock exchanges can not service their liabilities in full under current exchange and interest rates (see chart). This in turn implies Y% of loans could be non-performing. The shortage of equity capital in the corporate sector implies in turn that the non-performing loans in banking systems would unlikely be resolved in the next few years, with adverse consequences for overall confidence and credit allocation, i.e., a worsening of the credit crunch.

Chart on debt service difficulties and implied non-performing loans for these firms.

Source: Ferri et al. 1998

Estimates on the capitalization of banking systems confirm this bleak picture. Most private observers estimate ratios of non-performing to total loans for affected East Asian countries between 10 percent and 60 percent, with implied ratios of non-performing loans to GDP between 10 percent and 40 percent. Including distressed assets held by other financial institutions, such as insurance companies and investment funds, would raise these estimates of non-performing assets even further. While some costs of the financial restructuring will be borne by the private sector, most will be a fiscal liability, since governments have guaranteed the liabilities of many financial institutions, with costs for the government of up to 30 percent of GDP. These costs are very high, also relatively to other experiences. In Chile's 1982 banking crisis, from a fiscal point of view the most expensive banking crisis known to date, for example, the total fiscal costs were 45 percent of GDP.

Table on debt stocks, private, external, domestic, and non-performing loans as a percentage point of GDP, for all East Asian countries.

And add to credit crunch. As noted, many viable East Asian

an corporates suffer from a lack of external financing. While on aggregate liquidity is limited, it is not as limited as credit has become for good borrowers, especially small and medium sized ones. What liquidity is available has likely gone for debt rollovers to weak corporates and there have been increased shares of government securities and other safe assets in bank portfolios. As in other cases, many factors play a role in this credit crunch. There has been a flight to quality by depositors who are shifting money to more secure banks or offshore. But, even when kept on-shore, funds have not necessarily been available for lending, in part as governments have played an important role in influencing the allocation of this liquidity. In Thailand, for example, the Financial Institutions Development Fund (FIDF), part of the Bank of Thailand, has been an important vehicle for intermediation from more liquid, stronger banks to weaker, illiquid banks, charging an intermediation fee in the process to limit the use of this lender last resort facility. But, this intermediation has proven more attractive to many banks than lending to corporates.

The provision of credit has also been constricted by more stringent prudential regulations, especially more rigorous enforcement of (sometime higher) capital adequacy requirements. While largely unavoidable to restore confidence, this has added to the costs and lack of desire of banks to lend. Closure of insolvent banks and other financial institutions has also disrupted lender-borrower relationships. And banks have raised margins in an attempt to restore profitability, in the process reducing both the demand for financing and the supply of good firms able to pay the higher costs. Attempts to increase margins while limiting bank entry to restore bank profitability have often been attempted. The outcomes in these cases have most often led to severe costs to the economy and financial development. In the case of Korea, for example, limits on deposit rates contributed to the development of a curb market, later formalized in non-bank financial institutions and trust-account activities of commercial banks, which have aided to the recent financial instability. Resorting to financial repression, or even worse, inflation, to deal with non-performing assets is thus inferior to allocating government funds within an environment of tight monetary and fiscal policy.

#### Solutions

With have to restart the flow of credit. The tasks of corporate and financial sector restructuring are enormous. The immediate agenda is to restart the flow of credit in the affected economies. Such credit is needed desperately not only to resume normal business operations but also to facilitate the substantial resource shifts associated with the structural reforms including those resulting from the dramatic realignments of exchange rates. Restarting credit flows is also necessary to allow the maintenance of the asset values, which risk further depreciation rapidly. A major difficulty in unblocking credit channels lies, however, in the distressed financial state of a large proportion of firms and financial institutions. The large uncertainty surrounding the exchange rates and the abnormal, depressed state of the economy make it particularly difficult to ascertain their long-term viability or the value of their assets. Since this difficulty is unlikely to be resolved quickly (see next section), it will be necessary to address the stock and flow problems separately and distinguish between asset valuation and management issues.

To achieve this separation there will have to be a deliberate policy of making new financing for working capital purposes more senior to existing claims. This type of "debtor-in-possession," or

"DIP" financing, should provide seniority for those creditors willing to advance new moneys to debtors that are operationally viable but financially overextended. This granting of seniority is a normal procedure in market economies in the context of a firm in reorganization (most reorganization procedures treat financing for working capital and other short-term purposes extended to a borrower under formal reorganization as senior to most claims). It may have to be done on an emergency basis and for a large share of firms, however, as on one hand the size of the problem is much larger and on the other hand the institutional underpinnings for corporate reorganization are much weaker for these economies.

Export credit is another obvious priority. Trade finance based on export orders and lines of credit is one mechanism where stocks and flows can be separated. In trade financing, Indonesia, Korea and Thailand have already put in place public support programs, involving, among others, the purchase by the central banks of notes collateralized by export receipts and government support to commercial banks for the issuance of letters of credit. Indonesia, for example, is designing a pre-shipment export credit guarantee fund that will partially guarantee the credit risk of domestic banks on pre-shipment loans to exporters on a loan-by-loan basis. The guarantee fund is a temporary measure designed to help companies gain access to credit and thereby fund their operations until receipt of cash from purchasers.

Further government support for trade financing and working capital will be necessary in some countries. This need not be a direct and full credit guarantee by the government, but could be a guarantee on the performance of the better banks in the respective country, rather than a guarantee on particular loans or credits. In turn, this sovereign guarantee might be backstopped by third parties, such as has been the case for the trade financing facility in Indonesia and Thailand which are backstopped by multilateral and bilateral lenders. In addition, there might be need for other additional specialized financing facilities. Some other risks may also be peeled off through partial and temporary guarantees. Care should be taken that the support mechanisms do not distort the longer-run agenda.

Especially for SMEs. As in other financial crises, small and medium sized enterprises have been particularly severely affected by the credit crunch. Some progress has been made in this area. Special financing schemes for SMEs have been put in place in some countries. These need to be time-bound, however, transparent, and market-based in their terms. In addition, there may be high returns to interventions targeted at segments of the economy suffering a disproportionate impact of the banking crisis or financial contraction (e.g. rural credit) and those likely to stimulate aggregate demand and labor absorption. In the current crisis, greater priority may be assigned to ensuring, for instance, supply of credit at affordable rates to those parts of the rural sector affected by El Nino than to worrying about the possible distortions in the efficiency of resource allocation resulting from different borrowers facing different interest rates. Of course, care should be taken to avoid such differential treatments from becoming permanent features of the landscape.

And geared toward boosting the cash flow of corporates. Support has been provided through tax relief measures for corporates, which boost their cash flow and thus their credit standing. Support has also already come through



ome accounting measures, in particular deferred recognition of losses on foreign exchange liabilities, which has helped maintain the (measured) net worth value of corporates. In the short-run, further measures directly geared towards the corporate sector which are of a self-selective and relatively general nature, are likely to be the most effective: corporates are relatively strong in East Asia and in this way the adverse selection often associated with government directed schemes can be limited. Such schemes may include further tax and accounting relief, credit for collateralized transactions. As part of the tax rationalization, given the externalities the systemic risk associated with high debt-equity ratios, a good case can be made for introducing tax and regulatory policies to discourage overleveraging.

And also needs to involve foreign creditors.

There needs to be adequate relief and burden sharing, not just by domestic parties, which contributed to the crisis. The brunt of the adjustment has so far been borne by countries, with a reversal of capital flows of more than \$100 billion and very little burden sharing by external creditors. The government of Korea, for example, has assumed many liabilities of financial institutions and creditors have received government guarantees as well as higher spreads. But little private new external financing has been forthcoming. Indonesia has adopted a framework and rules governing the workout on external corporate debts (see box?), and received some relief on its public debt burden.

#### Box Indonesia Corp

##### orates External Debt Restructuring Scheme

The INDRA Program (officially launched on August 3, 1998) allows for Indonesian corporates to swap their outstanding foreign currency liabilities into rupiah at a rate that will be determined by the 20-day moving average of market exchange rates. The firms will then make repayments to the Indonesian Debt Restructuring Agency (INDRA) in rupiah, which, in turn, will repay the creditors in foreign currency. Bank Indonesia will administer INDRA. For the first three years of the program, the firms will make only interest payments to INDRA, while principal payments will be made in the subsequent five years. This will shift the associated foreign exchange risk of existing private corporate debts to the Indonesian government. INDRA will pay coverage for interest up to (Libor + 300) basis points. A pre-requisite for eligibility for INDRA support is for each firm to finalize a corporate restructuring plan with its creditors. About \$64 billion of external private corporate debt will be eligible for the scheme. In addition, an estimated at US\$9 billion inter-bank foreign currency debt of the domestic bank that are owed to foreign banks and maturing by March 31, 1999 will also be covered by the Central Bank (which is targeting a committed amount of US\$6 billion). The individual foreign banks will undertake efforts to maintain their level of trade credit provision (about US\$4-6 billion) as of end-April 1998. Debtors have until June 30, 1999 to utilize the INDRA program.

There is need, however, for additional external liquidity relief. {There maybe more need for standstills, and (additional) official financing). The role of workouts is being revisited under new international architecture. International coordination mechanisms are needed. Amars paras}

Mechanisms may need to involve picking winners. In some countries, this policy would have to be complemented with deliberate actions on the part of the government



of picking quickly winners, both in banks and corporates, which in turn implies less emphasis on dealing only with insolvent financial institutions. In Indonesia, for example, where no domestic financial institution may be solvent, it may be necessary to identify a few winners to intermediate credit while the asset issues are being resolved. The resumption of credit flows will thus importantly depend on developing mechanisms to support quickly some of the institutionally better-developed banks, and thereby corporates. While these banks may currently have weak asset portfolios, there is little alternative, short of shutting down the whole banking system, to support some banks soon, also as the institutionally strong banks will have to form the core of a restructured banking system. The support mechanisms can take a variety of forms, for example, protection for new (foreign) investors against further deterioration in asset quality or protection against exchange rate depreciations.

But, even with more breathing space, systemic restructuring will be necessary. Flow solutions and short-term interventions are unlikely sufficient to resolve the large problems in the financial and corporate sectors. And the current reluctance of foreign investors to allocate new funds to East Asian countries stems in good deal from their concerns of the overall approach. Policies involving accelerated restructuring involving government support are thus necessary in most East Asian countries. A large up-front investment by the public sector may lead to lower ultimate costs as the moral hazard of bailouts that are repeated maybe avoided and more generally as there are large benefits to getting the credit flows and the economies going again by resolving these problems.

#### 4. Systemic restructuring: principles and necessary conditions.

While elements have been put in place, e.g., approaches for dealing with insolvent financial institutions, the framework for corporate and financial restructuring is still incomplete in affected East Asian countries and there are some important missing pieces. In Korea, for example, the link between financial and corporate restructuring has not yet been resolved. In Indonesia, no mechanisms have been put in place to support those banks that will form the core of a new, restructured financial sector. And in none of the countries has the government made a commitment to allocate public resources commensurate with the (private) estimates for the costs of financial and corporate restructuring. Without comprehensive approaches, based on sound principles and workable mechanisms, countries will continue to risk a protracted period of uncertainty, limited resources, and slow economic growth. The framework will have to cover financial and corporate sector restructuring, availability of adequate fiscal resources, and supportive monetary and fiscal policies. And adequate sequencing of actions will be key.

##### Financial sector restructuring.

First principles.... International experiences suggest a number of principles for restructuring of financial institutions (see, among others, Sheng, 1996, Dziobek and Pazarbaolu, 1997, Caprio and Klingebiel, 1996, and De Juan, 1998). As a start, it is important to stop flow of new financing to bank borrowers that are in default and limit new lending to insolvent institutions that do not meet pre-specified criteria for managerial competence and financial performance. This is

often done too late, however, also in East Asia. In Thailand, the crisis was triggered by large-scale liquidity support amounting to 10% of GDP to finance companies. The central bank of Indonesia channeled large amounts of liquidity credits to weak banks, in case of some banks exceeding their equity several times over and equivalent to over three-quarters of total assets. In the process, the monetary base was expanded and losses on these credits had to be assumed by the government. In Korea, banks continued to extend "emergency" or "bankruptcy avoidance" loans to financially troubled corporations, often at the instigation of authorities, as late as early-1998.

Prompt action is an important ingredient of success. Restructuring mechanisms should also allocate losses transparently and minimize cost to the taxpayers, and preserve incentives for the infusion of new private capital. Of course, non-viable financial institutions should be closed and only viable institutions should stay in business. The process should strengthen financial discipline by allocating losses first to existing shareholders and requiring those creditors and depositors that can be construed to share some responsibility for the monitoring of the institutions' distress, to assume some losses. To the extent management was part of the problem, it may need to get changed as well, and banks need to be operationally restructured. Measures need to be taken to maintain credit discipline for bank borrowers. In several countries, borrowers have adopted the attitude that their creditors are less likely to be around in the future than they will be, thus reducing their incentives to repay, even when they can. Delays in financial sector restructuring will aggravate this phenomenon, lead to more capital flight, especially when liabilities are already guaranteed by the government, and make corporate restructuring more difficult.

Are hard to live by.... These principles, however, generally refer to situations where there are a limited number of insolvent financial institutions and the overall confidence in the financial sector is high. The systemic nature of financial distress makes the situation typically much more complicated. It is often not feasible or economically sensible to close or suspend a large segment of the financial sector. As noted, abrupt closing of some financial institutions in a situation of large uncertainty can also lead to depositors fleeing (even more) from banks, adding to the liquidity squeeze for banks and credit crunch for corporates with negative repercussions on corporate performance. The immediate challenge is thus to maintain confidence in the financial system while closing some financial institutions. To achieve this, countries are often inclined to quickly provide guarantees to depositors and creditors to stem the loss of confidence. This limits, however, their degrees of freedom in the future. And they might not be credible in the first place if the problems are large and the government lacks the resources and capacity needed to back them up, as was the case in Indonesia.

but can pay off. Yet, this does not mean that imposing losses on depositors and creditors will necessarily lead to a run on the banking system as a whole and consequently end in a contraction of aggregate money and credit, and output. In a number of cases, most notably USA (1933); Japan (1946); Argentina (1980/82); and Estonia (1992), governments resolved banking system crises by imposing some losses on depositors (or, at least, exposing depositors to possible losses). Even though losses were imposed on depositors there was little or no adverse macro-economic consequences or a significant flight to currency. Economic recovery was quite rapid and fin

ancial intermediation, including household deposits, was restored within a short period.

Box/charts: macroeconomic and financial sector developments in these countries (charts from Baer/Klingebiel) with household deposits, industrial production, gdp, other monetary aggregates; etc

In these and other cases, governments adopted the following five objectives. First, policy-makers undertook a comprehensive program of financial restructuring. Many other countries, in contrast, adopted intermittent regulatory intervention in depository institutions, which increased depositors' nervousness and damaged regulatory credibility, especially in cases where regulators had argued that the institutions were in fact solvent. Second, regulators restored public confidence in the system by demonstrating that the institutions remaining in operations were solvent and well capitalized. Measures used in some countries to signal this included injection of (private) capital into marginally solvent banks and relicensing procedures in cases in which the banking solvency crises affected a large portion of total financial system assets and deposits (this was, for example, used in the US in the 1930s). Third, old, partly distressed assets were separated from new assets, and old deposits were written down. In some cases, when it was difficult to mark assets to their true market value, claims were created which were junior to new deposits. This allowed viable financial institutions to maintain existing deposits to fund their existing assets and attract new deposits to fund profitable new investment opportunities, thus facilitating restructuring. This could only happen, however, if depositors were protected from the risk of the old, impaired asset portfolio. Fourth, to limit the public's desire to shift from deposits to currency, the relative return on deposits was correctly priced. Finally, the time frame over which deposits of insolvent banks were frozen was kept to a minimum. A complete deposit freeze or a lengthy workout over an extended period of time was avoided as this would have imposed additional costs to depositors through illiquidity (and foregone interest) on their unimpaired deposits, and increased flight of depositors to currency or other substitute assets.

Many countries chose not to, however, at a cost. In many other cases, less comprehensive solutions were adopted. Many countries, including several East Asian countries (Thailand (1983-87) and Indonesia (1994)), experienced a financial crisis that was in part resolved through partial or full public bailouts. These bailouts reinforced the perception of an implicit government guarantee on deposits, or even other bank liabilities, to the detriment of market discipline. In some cases, management of the restructured financial institutions was not even changed, which further undermined incentives for prudent behavior. In East Asia, the lingering effects of these past policies to deal with financial distress contributed to the present financial crisis. Japan, for example, has attempted for almost a decade now to resolve its financial sector difficulties through a policy of low interest rates, limited disclosure of the real losses in its financial system, and only sparing public support. Yet, success has been elusive, making this a poor role model. More importantly, other East Asian countries do not have the luxury of gradual reform.

Box on Japan?

More generally, most bank recapitalization programs using public resources in developing countries

s have been unsuccessful with recurrent recapitalization the norm (see World Bank 1995). Once banks encountered a solvency problem, efforts mainly fixed the balance sheets but were less effective in correcting the underlying conditions that led to the problems. When facing the tradeoff between maintaining confidence in the short-run and preserving incentives for good banking (i.e., minimizing moral hazard), most countries have favored maintaining confidence by extending large-scale guarantees or continue recapitalizing banks. Corrective efforts thus led to moral hazard and created perverse incentives, thus undermining confidence in the medium-run, and often the short-run as well. In transition economies, for example, recurrent recapitalization was the norm, rather than the exception. Hungary, for example, recapitalized its banks five times before it got it right. Venezuela has repeatedly restructured its banks. Even in industrial countries recurrent recapitalizations have not been avoided, e.g., Credit Lyonnais. These experiences show that piecemeal, untransparent and unnecessarily delayed responses weaken confidence, lead to more moral hazard, and thus increase the size of the problem.

As they lacked to put in place the supportive fundamental reforms. In systemic crisis situations, comprehensive (in one go) solutions are thus preferable to several attempts. Managing financial system distress is a process, however, not an event and can not be rushed without achieving some fundamental reforms. A key missing element in failed, more comprehensive attempts was a change in the underlying rules of the game. Regulations of financial institutions, and enforcement thereof, the role of the market in disciplining financial institutions, accounting framework and other structural factors have to change to assure public resources are not squandered. This implies a tradeoff, as it will take time to put some of these measures in place. In the meantime, the government will need to restore confidence. While there are no recipes or exact science to follow, some basic processes need to be observed and some lessons can be applied even in the first stages of crisis management.

The process of systemic financial sector restructuring starts with ... Managing financial system distress starts with stopping the flow of bad lending and diagnosing the (size of the) problem and ends with actions such as closures of individual financial institutions, nationalization, liquidation, disposition of assets, etc. The first step in this process should be to diagnose the size of the problem. To develop an assessment of the overall size of the problem, a rigorous program of performance monitoring of all financial institutions, including detailed portfolio reviews by reputable outside auditors (preferably internationally recognized accounting firms) will be required. This will help determine the best course of action and ensure that new public resources are not being squandered. It will be also necessary that the problem get immediate, focused, high-level attention. This requires forming a dedicated, high-level crisis team to coordinate the government's response to the crisis. The team should develop specific basic operating assumptions and principles to be employed in tackling the crisis and develop the agenda of immediate tasks and the general scope and direction of next steps.

Most government in affected East Asian countries have been moving along this path and institutional structures for dealing with financial distress have emerged. In Thailand, the Ministry of Finance has taken on a lead role in the resolution of the finance companies. In Indonesia, the Indonesian Bank Restructuring Agency (IBRA) directs the restructuring of all comm



ercial banks and in Korea, the Financial Supervisory Commission (FSC) is coordinating the restructuring of the financial (and corporate) sector. A number of (suspended) financial institutions have been evaluated as to their viability and closed if necessary using a variety of tools. Diagnostic reviews and stress tests of financial institutions are underway in most countries. Many weak financial institutions have been required to submit rehabilitation plans containing capital increase measures, progressive cost reductions, measures taken to limit the accumulation of and reduce non-performing assets, and management improvements. Targets have been set for capital adequacy and performance criteria, most notably for evaluation and management of non-performing loans. In some countries, independent accounting and consultant firms are evaluating these plans. This evaluation has typically included the development of templates and forward-looking analytical modeling tools to evaluate the realism of rehabilitation plans of banks. Appraisal committees have then decided on the feasibility of rehabilitation plans and the appropriate course of actions for those banks with rehabilitation plans not deemed feasible.

Box: Differentiation among various types of banks; diagnostic reviews; rehabilitation plans;

Note: So far little use

has been made of private information in the selection of financial institutions (forms of government support with sharing features). Laura Ard

In a number

of institutional dimensions, these processes need to be strengthened, however.

There is a need for greater empowerment of a single agency whether in the central bank, ministry of finance or other agency with the task of restructuring the financial system to avoid gaps and conflicts in approaches and actions. In Korea, for example, while the FSC is formally in charge of the restructuring, it still needs to consult extensively with other arms of the government, including the ministry of finance, the central banks and presidential advisors. The decision processes for evaluating rehabilitation and restructuring plans of individual financial institutions need to be given more integrity, including through the participation of independent parties, including internationally recognized experts. More generally, there is a greater need for various types of third-party inputs and technical assistance necessary at each phase. This involves diagnostic audits of financial institutions, followed by loan workout skills to create viable, restructured assets, and investment banking skills to sell some of the acquired, restructured assets. In many countries, adequate safeguards have also not yet been built in during the evaluation and decision processes, transparency has been limited, and conflict of interest has arisen. As a result, the processes have not always led to a restoration of confidence among investors and depositors. Market reaction to the acquisition of 5 weak banks by other Korean banks in July 1998 was adverse, for example, as details on the process followed and the availability of government support for the acquiring banks were limited. In general, introducing more of global practices could strengthen the closure processes used for insolvent financial institutions.

Box: Dealing with unviable financial institutions

Weak financial institutions can be closed and liquidated, or they can be merged, partitioned, or rehabilitated. The option that is least costly to the government is to be preferred, but the form of intervention to be recommended can depend on the bank's financial condition, its poten

tial viability and importance to the economy, and the overall degree of financial distress. Even though approaches differ greatly between countries, varying from more formal approaches in the US to more informal approaches in continental Europe and Japan, international best practice suggests a number of principles.

In the direst cases, the most cost-effective resolution for the failed institution may be closure, liquidation and deposit payout. Closure is equivalent to revoking the bank's license, preferably after arrangements have been made to accommodate its creditors and debtors. In these circumstances, the government seizes the bank; then the appointed receiver liquidates the assets and uses the proceeds to pay the bank's depositors and creditors, in full or in part, according to the legal priority of their claims. As it takes time to sell the assets, the government may pay depositors promptly either from an accumulated deposit insurance fund or by advancing the necessary funds pending the sale of the bank's assets. Closure and liquidation can be very disruptive to the community, whereas the sale or merger of a bank is less disruptive and preferable where the sum of the bank's franchise value and the expected proceeds from the sale of the assets exceeds expected proceeds from the liquidation of assets. Indeed, the expected proceeds are likely to be higher where assets are retained by their issuing bank because information costs cause loans to lose value elsewhere. However, in the current Asian crisis franchises frequently have no value, in which case liquidation may then be the least costly option.

To minimize disruption, troubled banks can be partitioned into marketable and unsaleable pieces. For banks whose assets are in such bad condition that it is not cost-effective to market them immediately, the government may arrange a deposit transfer of all or only the insured deposits to another financial institution that will service the deposits and provide deposit services. This option is particularly useful where the government has guaranteed deposits. The government will take over the bank's assets for disposal, although it will also need to provide good assets to compensate the acquirer for assuming the deposits.

Nonviable banks may be closed (preferably only momentarily) and their assets partitioned after careful, independent and professional scrutiny, into good and bad categories. At closure, shareholders' claims can be written down, completely where the bank is insolvent or partially where some equity remains. The claims of other low-seniority creditors can also be written down according to the legal priorities in place, if these claims have not been guaranteed. All of the assets and any franchise value of the liabilities assumed may be purchased by a healthy bank in a wholebank purchase and assumption (P&A) transaction. For banks in a worse condition, the P&A may cover only some of the assets and liabilities, in which case the transaction might be called a goodbank P&A. If net worth is negative, government support will probably be needed to make the bank saleable and it will increase as the proportion of the assets and liabilities to be transferred to the acquiring bank rises.

The government may replace the worst assets with cash, bonds, or other valuable assets, and/or cancel some creditors' claims. In such circumstances, it has to manage and market the bad assets it acquires, but at least some of the assets and liabilities remain in private hands.

There will be a tendency for prospective buyers to place a low value on the assets in order to gain maximum advantage in bargaining, implicitly demanding a government subsidy at the time of purchase. In addition, uncertainty regarding future profitability in a crisis causes potential acquirers to heavily discount values. Competitive bidding among as many would-be acquirers as possible for the whole bank or for pools of homogeneous

assets will temper the attempt to gain bargaining advantage. Another way to reduce the discount for uncertainty and obtain a better price is through guarantees, loss sharing, stop loss, and/or income maintenance agreements or arrangements that allow acquirers to put bad assets back to the government at a preagreed price within a specified time period. While these solutions raise the immediate price of assets, they require contingent public assistance in the future, so that their costs and benefits need to be carefully assessed. The costs of such arrangements can also be counter balanced by giving the government a share in the upside potential through warrants, stock options, or profit sharing.

In other

situations, where the troubled bank is large and essential to the economy, the government may prefer to restore it to viable condition, rather than permanently terminating its license. If no comprehensive guarantee is in place, liabilities can be written down. To keep the institution functioning while writing down the claims of shareholders and low priority creditors, the government may momentarily close the bank and reopen it immediately with a new license, with the government as the temporary owner, and fewer liabilities. It may choose to remove some of the bad assets in the process. This bridge bank will be under government control while it is rehabilitated; then, it should be sold at the earliest opportunity into private hands, domestic or foreign.

The bridge bank has the

benefit of providing uninterrupted service to borrowers and some creditors. Commitments to borrowers will be honored, for example, so they are not suddenly forced to find new lenders for their working capital and other financial needs. This arrangement also gives the receiver a few months to effect a resolution by allowing potential purchasers time to conduct due diligence, value the large and complex bank, and prepare their bids. On the other hand, it has the disadvantage of requiring the government to take two sets of actions: first to take over the bank and bridge it, and then find a final solution. During this time the government or its agents must run the bank and take the risk of further deterioration in the economy or that their own weak management will further depreciate the bank's value. Good employees and valuable customers may leave during the bridging hiatus. For these reasons, the government may choose to rehabilitate an existing bank by taking a longer term partial or full ownership position in it rather than form a temporary bridge.

To minimize government outlays in normal time

s, a viable or moderately troubled bank can be acquired by another, preferably healthy bank and its license voluntarily terminated. In the East Asian crisis, some governments have taken a proactive approach and have arranged, or even forced the merger of a troubled bank with or without assistance. Should a merger be the preferred approach, it should be arranged before the bank closes its doors; in fact, its offices can be immediately available as branches of the acquiring bank to service loans and deposits. This method has the benefit of keeping the assets and liabilities in private hands, minimizing disruption to the community, and preserving the bank's franchise value.

Source: SFO/MAE note: Strategic

For Systemic Bank Recapitalization And The Use Of Public Funds

#### Complementary

institutional changes are necessary. A number of complementary regulatory measures are necessary to allow for a more fundamental change in the rules of the game. These involve important changes in the regulatory framework. To some degree this has happened in East Asia. Countries have recognized the need to bring standards for loan classifications and loan provisioning closer to interna

tional practice and enhance capital adequacy requirements for financial institutions. Countries made some progress in enhancing disclosure requirements, increasing the legal duties and responsibilities of financial institution managers, and promoting greater roles for outside investors. Countries have further opened their markets to foreign investors through more liberal rules for the purchases of domestic assets (both capital markets instruments and foreign direct investment) and easing local establishment. Korea, for example, has abolished most previous ownership restrictions for foreign investors; Thailand now allows foreign ownership of banks; and Indonesia has completely liberalized foreign ownership of almost all types of financial institutions.

Countries have made some progress in enacting the tools for financial sector restructuring, including the institutional and legal framework for resolving distressed financial institutions and dealing with non-performing assets. Closure processes have been improved to give the authorities more powers to intervene in weak banks and the ability to (fully) write down of shareholder equity, but are still far from international best practice. The independence of regulators has been somewhat enhanced, in part through new regulatory structures, such as in Korea.

Albeit many still need to be implemented. Many elements of international best practice (as adopted, for example, in the 25 Core Principles for Effective Banking Supervision) still need to be put in place, however. Legal reforms still need to be expanded and deepened to become effective tools for systemic bank restructuring. Of course, these best international practices need to be adapted to the existing legal and judicial framework to make the legislative modifications supportive of the program. And, while legal and regulatory measures need to be tough, they also need to be realistic.

The necessary legal measures progress in stages from emergency measures to restore confidence in the banking system (such as deposit guarantees, strengthened prudential regulation, adoption of internationally accepted accounting and auditing standards, and enhanced compliance programs) through the creation of new government entities or other mechanisms for resolving failed institutions and disposing of their assets (see Box). As bank restructuring is inseparably linked to the ability to maximize recovery on non-performing loans, held by insolvent banks or asset management corporations, bankruptcy and corporate reorganizations laws, market incentives that encourage debt rescheduling, and the legal capacity of government and private sector entities to convert debt into equity need to be adequate as well. Also, decision-makers need to be better protected against personal liability action by private parties affected by their decisions.

#### Box: The Necessary Legal Framework for Systemic Bank Restructuring.

The legal issues that need to be addressed in rebuilding the legal system at the same time that the banking system is being restructured include:

- transparent forms of ownership that clearly define the legal structure and liability of borrowers;
- judicial and alternative dispute resolution mechanisms that can be relied upon to enforce contracts;
- accurate and maintained title records



registries for all categories of property used as loan collateral, including access to lien information; and established procedures and institutions for handling the conversion of collateral into cash in a timely and efficient manner.

Without these legal foundations, any systemic bank restructuring no matter how successful it appears will only be temporary until the next banking crisis.

Source:

Margery Waxman, A Legal Framework for Systemic Bank Restructuring, World Bank mimeo

Regulatory measures in the areas of information disclosure, enhanced corporate governance of financial institutions, also need to be further enhanced. Some operational changes and other fundamental reforms (e.g., creating holding companies for financial institutions) are necessary in some countries. The structure of financial services provision needs to be revisited in most countries so as to allow greater and fairer competition among financial sector providers and to create more stable financial sectors. The independence of regulators needs to be enhanced in almost all countries. And the disciplining role of the market needs to be further enhanced (one model is to require all banks to issue subordinated debt, see accompanying paper for this and other measures used to strengthen financial systems).

Structured, early intervention in weak financial institutions is necessary. Importantly, procedures need to be put in place dictating prompt correct actions and structured early intervention and resolution in case of distressed financial institutions, so as to allow imposition of sanctions before actual insolvency is reached. Such a scheme was adopted in the US in 1991 as part of the deposit insurance reform (The Federal Deposit Insurance Corporation Improvement Act of 1991) and appears to have contributed to the recovery of the US banking system. The scheme laid down a set of Prompt Corrective Actions which intensities increase with the degree of under-capitalization of the financial institution. It provides for objective criteria and formal procedures that mandate remedial action by supervisors commensurate with the degree of financial or management weaknesses that are detected. The corrective steps to be undertaken involve (roughly in order of intensity): limits on deposit taking, suspensions of dividends, requirement of a capital restoration plan, restrictions on asset growth, approvals required for acquisition, branching and new activities, ordering of recapitalization by existing owners, restricting inter-affiliate transactions, restricting deposit rates, restrict pay of officers, suspension of payment on subordinated debt, restricting certain other activities, initiation of resolution process, and initiation of receivership/conservatorship. The US PCA-scheme can serve as a useful starting point for considering the appropriate institutional framework for intervening in troubled financial institutions in affected East Asian countries (see Kaufmann, 1998).

Such strict

guidelines on dealing with insolvent financial institutions are necessary since without clarity on the rules under which financial institutions are allowed to continue to operate, countries risk too much forbearance (Box). To date, most East Asian countries fall short of this clarity in regulatory interventions in weak banks. For example, several countries still allow dividend payments by undercapitalized banks (in Japan, for example, dividend payments continue at the same time as banks are declaring large losses). Developing the institut

ional framework supporting these legal and regulatory changes will, however, require sustained efforts.

Box: Forbearance: Never? If ever, so how good should fundamentals be?

Forbearance can include more lenient tax treatments, lower tax rates, lower reserve requirements, specific more lenient regulatory accounting practices, guarantees on bank assets and/or liabilities, lower interest rates on Central Bank liquidity support, and forbearance in practice (i.e., allowing violation of rules). Forbearance can thus be structured, i.e., adopted as a policy measure and applied to the whole industry (e.g., lowering capital adequacy requirements, limiting provisioning, granting accounting relief, e.g., on foreign exchange losses) or implicit, i.e., normal rules, but allowing violations for either individual banks or a whole banking system. Forbearance has been applied in industrial countries. For example, during the 1980s developing countries debt crisis banks were allowed to continue treating impaired sovereign claims as performing loans (as otherwise major banks would have had to be declared insolvent). During the 1930s US-depression, banks were allowed to continue operating even though many were technically insolvent.

Experience with forbearance

in the US Savings and Loan, S&L, industry suggests it should be adopted only very cautiously. Before the recognition of the deteriorating conditions of the S&L industry, US regulators tried several forbearance techniques. These included a program that allowed the government to deposit funds in a failing S&L in return for a net worth certificate, which could then be treated by the institution as regulatory capital. Although, this policy helped the assisted institutions to deal with the effects of then very high interest rates, the long-term, unintended effect was for regulators and institutions to look for forbearance solutions. Other measures included specific more lenient regulatory accounting practices that had similar effects. The final cost of this forbearance was very high. This poor experience with forbearance has also been the case in developing countries. In the Philippines in the 1980s, regulatory forbearance contributed to the banking crisis, as well as directed credits corruption, and macroeconomic deterioration. Bad banks were not closed even when their condition was known, provisioning regulations were regularly waived, and banks were ordered to lend to weak companies. In the end, both commercial banks and the Philippine central bank needed to be recapitalized.

Because of the dangers of their misuse,

some propose that forbearance be forsworn completely. Others argue that they have a useful role to play in some circumstances, for example, in cases of systemic shock with otherwise sound financial institutions, where economic recovery is deemed imminent. It is in any case clear that forbearance measures should in no case be used in situations where they involve a subsidy to existing owners that have been at fault in the troubled banks present condition. They should not be used in cases of a systemic shock with institutionally poorly developed financial institutions. It should also be realized that forbearance instruments all have fiscal implications, either directly or indirectly, later if not immediately (typically, instruments used for forbearance fail the test of transparency as they are adopted to avoid an immediate impact on the budget and provide assistance that is not apparent to the public). If they are to be used, they should be adopted only if they are cost-effective in reducing the discounted present value of the total assistance package.

Source: Waxman/FDIC/CBO, 1993. S

F/MAE note

But some other reforms can be phased in. This is not to say that all of these reforms need not be effective immediately, particularly loan-loss provisioning and capital adequacy requirements. To some degree, they can be phased in over time so that banks can adjust and build up their capital. But, it will be important to ensure that such forbearance does not result in banks management engaging in (further) imprudent risk-taking in the meantime. There are many examples of zombie banks which had lost their own capital and were essentially insolvent, but were able to continue to attract funds as they operated under an umbrella of implicit government guarantees. Without putting any own money at stakes, these banks engaged in risky lending to try to make profits, knowing that the government covered the downside. Some Korean banks, for example, which had weak corporate governance anyhow, engaged in large-scale lending to Indonesian corporates in early 1997, while their own capital base was already eroded.

Implicit forbearance and forbearance alone is thus an unwise policy (see Box). When as a part of forbearance, provisioning rules are phased in, for example, loan classification standards should be tightened. Banks may also be given some tax relief, importantly on the provisioning for non-performing loans, so as to increase their retained earnings and thus to boost their capital. Capital adequacy targets should be made realistic with the projected profitability of banks and the amount of public support that is available. When announced, capital adequacy requirements should be meaningful and banks should be held to these standards by rigorous portfolio audits.

Some other regulatory reforms may aggravate matters at various steps of systemic bank and corporate restructuring. Full disclosure of non-performing assets may not be wise in the initial phase of a financial crisis, for example, as this risks further loss of confidence. But the authorities should have up to date (confidential) information on the liquidity and solvency positions of individual financial institutions and perform stress tests to identify vulnerabilities, thereby allowing them to take proactive measures, even when not necessarily disclosing all this information to the market.

The most difficult to achieve are the necessary changes in the rules, attitudes and institutional settings more generally. The independence of regulators will often need to be enhanced to allow a long-lasting change. This is especially the case in East Asia, where the long history of links between corporates, banks and government will only be broken if regulatory agencies become truly independent. Other type of changes, which can sustain a systemic crisis, will require a broader consensus. Most countries fail in the first instance to develop a more general consensus regarding the restructuring program. A better awareness among the general public regarding the complexity of the process is necessary, requiring deliberate public relations activities.

And, most importantly, a vision. The whole process of systemic bank restructuring needs to be driven by an well-articulated, medium-term vision for the financial and corporate sector. This vision, as well as the short-term interventions following from it, needs to be developed by the government in collaboration with the private sector. Private sector, both domestic and foreign, is essential, both for the design and for confidence. In too many cases have asset value depreciated,

for example, as there was too little involvement by the private sector in the design of the asset recovery mechanisms. Even though it may be hard to pin down the exact parameters of this vision, some medium-term view will be necessary, as it will be the starting point for the whole restructuring strategy. This vision should cover, among others, the structure of provision of financial services, i.e., the role of various types of financial institutions in providing financial services. Several East Asian countries need to consider, for example, what role is envisioned for finance companies and merchant banks. Is there really a need for these institutions, could they not be part of the commercial banks, as subsidiaries? If they are nevertheless allowed to exist, what is their franchise value of their license, a necessity for their survival and prudent behavior?

The vision also needs to articulate what the expected concentration is of the financial industry, e.g., how many banks of what size are expected to emerge from the restructuring? Too many banks can undermine stability as franchise value is reduced. Indonesia has more than 200 banks, for example, probably many times what is needed for an economy the size of Indonesia. Any financial sector restructuring for Indonesia will thus have to consider the future structure of the banking system. Also, what role is envisioned of foreign investors, both in terms of ownership of financial firms and of financial assets? And, what is the restructuring in the real sector expected to lead to, in particular in terms of the ownership and governance of firms and the links between the financial sector and corporate sector. Even though the whole process of systemic restructuring will take considerable amount of time (several years or more) and various steps, the markets will demand the development of an overall strategy as it will drive this process.

#### Corporate restructuring.

##### The immediate challenge

is to maintain sufficient working capital to firms. East Asia has many world-class companies that have been the engine behind the rapid economic growth this region has experienced in the past. They now risk having insufficient working capital and trade financing and being pushed into lower levels of output, and possibly liquidation. The current strategy imposes high costs on corporates, through the credit crunch and otherwise, and provides them with little breathing space to undertake the complex operational restructuring. Short-run interventions are thus necessary (see above).

##### Accelerate corporate restructuring. The

next main priority in East Asian countries is to accelerate the process of corporate financial and operational restructuring. Corporate debt is generally large with high debt to equity ratio. This heavy debt burden, a substantial and increasing part of which is now of a problem status, is a major reason for the current deep and widespread distress in the corporate sectors (World Bank, 1998a). Lowering this high corporate leverage is essential to corporate revival and reducing corporate vulnerability to future shocks. Restructuring corporate debt and operationally restructuring of corporates is also essential to successful financial sector restructuring. To date, restructuring has only happened to a limited degree at the level of the individual assets, and most has happened at the level of the economy, such as through general reschedulings and socialization of losses. This is not an efficient solution, however.



## Approaches to i

individual corporate restructuring will have to differ by type of enterprises. In case of state enterprises, key in the short-run will be to preserve their asset value. This will require market-based prices for their inputs and outputs, and preventing the buildup of arrears on supplies to corporates. Regulatory systems will need to be designed to ensure the competitive behavior of (quasi-) utilities. As a next step, state enterprises can be privatized, which will also aid the deepening of capital markets. For small and medium-sized enterprises, across the board procedures may be necessary in the short-run. The difficult case concerns the large private enterprises, which are the focus of discussion here.

For these enterprises, the challenge is to design mechanisms to prevent potentially viable enterprises from becoming permanently unviable due to lack of credit or justifiable financial relief and to restore working capital financing to viable enterprises. The main elements of such a sustainable corporate restructuring are fourfold: improving the enabling environment; development of the framework for corporate restructuring; enhancing the capacity of various actors; and a greater role for capital markets.

### Improve the enabling environment

Given the magnitude of corporate over-indebtedness, an effective resolution strategy will have to include workouts between corporations and their creditors, involving debt maturity extensions, debt-equity swaps, debt write-downs, etc., while corporates undertake operational restructurings. Some elements of a framework for such workouts with corporate debtors have been put in place in some East Asian countries. All countries have recently tried to facilitate enterprise restructuring through improving the enabling environment, including through better accounting and disclosure standards, enhanced bankruptcy and foreclosure processes, and changes in taxation and accounting rules (see Table). Indonesia amended its bankruptcy code in August, 1998, Thailand revised its bankruptcy law in March 1998, and Korea has introduced some revisions in its corporate reorganization procedures on February 14, 1998, with some further revisions in the Corporate Reorganization, Composition and Bankruptcy Acts on ?.

### Table on I

Legal/regulatory improvements in East Asian countries (from EASPR?)

### Many of the

se changes are, however, still far from what international best practice would suggest (see box). To further facilitate the legal process of disposition and restructuring of assets, governments could, for example, provide for pre-packaged compositions or reorganizations in cases where a large majority, say, 75% or more of participating creditors support the proposed settlement. Courts could be given a limited amount of time, say, 30 days to approve or modify the settlement, so that the process is not encumbered by long legal procedures.

### Box Inte

International best practice debtor-creditor regimes

From G-22, to be done

1. Crea  
tion of security interest

2. Priority
  3. Registration of security interest
- Enforcement

Other measures to improve the enabling environment for corporate debt restructuring have included liberalizing the foreign investment regime and merger and acquisition rules, opening up the capital and real estate market, and reform of tax treatment of restructured assets. Further tax and regulatory changes to encourage debt to equity conversions, and facilitate asset sales, whether on a temporary or permanent basis, are underway in some countries, with the changes in Thailand the most extensive to date. In most countries these should be extended to include, for example, deferral of taxable gains on corporate mergers and non-cash acquisitions. Tax systems could allow for opportunities for a corporate acquirer or new merged entity to use net operating loss tax carry-forwards from an acquired entity or pre-merger entities. Extension of temporary tax relief with appropriate safeguards to debt restructuring transactions involving any creditor (e.g., suppliers, bondholders) not related to the debtor may be considered. And tax relief for debt restructuring should include not just asset transfers to financial institutions, but also cases where debtors sell assets and use the proceeds to service debt. And, from a medium-term perspective, the biases in the tax treatment (and enforcement thereof) of debt versus equity need to be redressed.

**Enhance Framework for Corporate Restructuring.** While these changes will help facilitate individual corporate restructuring, it is becoming clear, given the scale of problems, that workout mechanisms outside the formal reorganization and bankruptcy procedures are necessary. Reliance on voluntary corporate restructuring will be key to avoiding overload of the court system and the needless dissipation of assets, destruction of equity, and extra economic dislocation. Following examples in Mexico (the UCABE-scheme), some transition economies, and elsewhere, affected East Asian countries are moving in this direction. In Korea, for example, an overall framework of principles and procedures has been adopted, which relies on contract law, rather than formal legal procedures. The framework covers the inter-creditor negotiations with rules on the share of creditors needed to agree on a restructuring plan and the conditions for standstill and rescheduling of claims. It also establishes an arbitration committee with appropriate rules and adequate authority, to assist in the workouts and to provide a means to resolve inter-creditor disputes.

**In Thailand**  
and, A Corporate Debt Restructuring Committee (CDRC) chaired by the Governor of the Bank of Thailand and including representatives from the Thai Bankers Association, Foreign Bankers Association, Federation of Thai Industries, Chamber of Commerce, and Association of Finance Companies has been formed to establish a framework and procedures for voluntary corporate restructuring. So called London rules, first promulgated by the Bank of England, have been adopted which will govern the out-of-court, corporate restructuring. Malaysia and Indonesia also have adopted variation of these mechanisms. Other mechanisms could also be usefully introduced, which rely more on auction processes, and may thus be quicker, see box.

Box: International experience in out-of-court corporate restructuring

Thailand and several other East Asian countries have adopted a variation of the so-called London Rules. The stated objectives in case of Thailand are: to benefit creditors, shareholders, employees, and the Thai economy by (i) minimizing losses to all parties through coordinated workouts. (ii) avoiding companies being placed unnecessarily into liquidation, thereby preserving jobs and productive capacity wherever feasible.

The principles adopted are:

Any restructuring

should achieve a business, rather than just a financial, restructuring to ensure the long-term viability of the debtor and maximize enterprise value.

Priori

ty must be given to rehabilitate assets to performing status in full compliance with applicable Bank of Thailand regulations.

Each stage of the private restru

cturing process must occur in a timely manner and at least in the timeframe required for a court supervised reorganization under the Thai Bankruptcy Act.

If t

he debtors management is providing full and accurate information on schedule and participating in all Creditor Committee meetings, creditors shall standstill for a defined, extendable period so informed orderly decisions could be made.

B

oth creditors and debtors must recognize the absolute necessity of active senior management involvement throughout the duration of the debt restructure.

A lead

d institution, and a designated individual within the lead institution, must be appointed early in the restructuring process and actively manage and coordinate the entire process according to defined objectives and deadlines.

In major mu

lti-creditor cases, after appointment of the lead institution a steering committee representative of a broad range of creditor interests should be appointed.

Decisions should be made on complete and accurate information, which has been independently verified to ensure transparency.

Accountants, attorneys, and profe

ssional advisors should have requisite local knowledge, expertise, and available dedicated resources.

While it is normal practice to request the debtor to ass

ume all the costs of professional advisors, lead institutions, and Creditors Committees, creditors have a direct economic interest, and hence a professional obligation, to help control such costs.

The Ministry of Finance and the Bank of

Thailand can have critical roles in corporate debt restructuring.

Creditors exi

sting collateral rights must continue.

Credit extended during the restructuring

process on reasonable terms in order that the debtor may continue operations should receive priority status.

Lenders should seek to lower their risk, and hen

ce their requisite returns, through an improved security package and profitability-based benefits rather than increased interest rates and imposition of restructuring fees.

Debt trading is encouraged under certain conditions, but the sel

ling creditor has the professional obligation to ensure the buyer does not have a detrimental effect on the restructuring process.

Restructuring losses should

be incurred amongst interested parties in the normal order of standard restructurings and reorganizations.

Creditors retain the right to exercise independent commercial judgement and objectives, but should carefully consider the impact of any action on the Thai economy, other creditors, and potentially viable debtors.

Source: Bill Mako

Or TADA, Market-based debt reduction, by S. Ramachandran

Nevertheless, as the restructuring of corporates has only started in earnest, these frameworks remain largely untested. And, these arrangements need to be backed up by one hand credible mechanisms to take firms into liquidation if necessary and on the other mechanisms to assure that viable corporates pay their obligations to the extent financially possible. In this respect, a generally weak area in many East Asian countries remains foreclosure of collateral and real estate, which takes often several years, and which will take considerable effort to improve. Importantly, the mechanisms adopted today rely will only be effective if agents have the institutional capacity and the right incentives to take restructuring on such a large scale.

Enhance the capacity of various agents

Banks are expected to play an important role in workouts. The model in most countries is to establish workout units in lead banks. In Korea, a lead-bank have been selected for each of the about 700 entities which are candidates for restructuring. A timeline on review and subsequent workouts of subsidiaries of large conglomerates has also been agreed. The framework provides for guidelines on the initial selection (triage) of viable, restructuring, and liquidation candidates. The lead bank will take main responsibility for leading the voluntary corporate workouts and each of the banks have established workout units, with financial advisors to assist.

Yet, many banks in East Asia lacked capacity

even in credit analysis, as they past lending behavior in part shows, let alone in debt rescheduling and corporate workouts. There is also lack of experience of banks in managing the equity interests possibly acquired as a result of debt-equity conversions. To remedy this, some technical assistance to finance outside advisors and the development of local capacity is being provided, but this will take substantial time. Corporates have equally limited skills in financial restructuring. Chaebols in Korea, for example, with the exception of the top 5 chaebols, have little or no experience in dealing with financial advisors. The number of corporates to restructure is also very large. In Thailand, only 4% of corporate debt had been restructured as of mid-July 1998, a year after the crisis broke. Only 18 voluntary corporate workout cases will be attempted under the new scheme before end-1998, out of 200 cases already identified and .. number of large firms with identified potential cash-flow problems (Claessens et al. 1998).

Expand the role for capital markets in corporate restructuring. The

damage to balance sheets and profitability of corporates will require an increasing role for capital markets to help fund the massive recapitalization needs. Capital markets development to facilitate corporate restructuring has been accelerated through regulatory changes. To allow for the transfer of converted equity from banks balance sheets, Korea, for example, has allowed special purpose



vehicles to hold the equity resulting from debt to equity conversions. Another nexus of banking and capital markets, especially for undercapitalized banks that are trying to shrink the balance sheet, will be creating secondary markets to bundle and securitize (distressed) loans. In this context, making it easier to buy and sell domestic bank loans will help banks liquidity, and facilitate dealing with the debt overhang. Laws allowing asset backed securities have been adopted in Korea and Thailand (?). It will require, however, some proactive steps from governments to fully develop such markets, for example, through better settlement procedures and standardized loan documentation. Other capital markets changes are required, however (see further Box).

Box: The role of capital

markets in corporate and bank restructuring

A balanced and competitive financial

system, open to foreign participation in the banking system, and in which capital is allocated in a transparent fashion and with appropriate consideration for risk is needed in Asia. Increasing reliance on capital markets will have attendant benefits for capital mobilization in terms of risk assessment and pricing, and dispersion of risk across participants. Transparency on future corporate discipline would have salutary benefits on economic performance. Therefore, in addition to the urgent challenges of rehabilitating the banking system, a concerted effort of the policy agenda in Asia should strive to develop domestic bond and equity markets, including the use of capital markets to securitize assets. Capital markets can help fund the massive recapitalization needs in banks and corporates, and can also be used to securitize assets.

Source: Michael Pome

reano

Resolving specific East Asian, institutional issues. There are a number of issues specific to East Asia. In Korea, large cross-guarantees between subsidiaries of chaebols have been delaying the corporate restructuring. They obscure the relationships between firms within a group and have allowed chaebol founders to control a large of firms with little of their own equity. In a restructuring of a weaker firm within a chaebol, banks are reluctant to give up guarantees from a stronger firm. And chaebols founders are reluctant to give up the guarantee, as they will lose control. While the government is committed to eliminating cross-guarantees completely by the year 2000, the process of resolving cross-guarantees at the individual firm level needs to be accelerated at the individual firm-level.

The government has developed the parameters of a market-based approach to the reduction of cross debt guarantees, which will, among others, allow for the conversion of guarantees into equity or warrants. Improved disclosure of financial information to banks by corporations and FSC has been required. But cross-guarantees are still a major obstacle to corporate restructuring as are the controlling shareholders that are also managers of firms. {Other East Asia specific issues?}

Make adequate public resources available

T

he large amounts of distressed assets to be resolved will involve substantial costs and require the use of public funds. Banks need to be recapitalize as they write-off loans and convert some loans into equity. Losses in some other financial

financial institutions may need to be covered. Some corporates may need to receive public support. Estimates for the total fiscal costs in affected East Asian countries are high, also compared to other experiences.

Chart: estimates for fiscal costs, compared to past crises. Table on fiscal resources required? Box on stock versus flow costs of fiscal assistance. From East Asia Recovery Paper, to coordinate with Kawai.

Which implies fiscal resources need to be ample.

The instinctive reaction is to allocate too little financing. The support typically made available initially to financial restructuring is often inadequate to tackle the problem and the approach to financing the costs of resolving the financial sector problems is very piecemeal and fragmented. This undermines the governments position vis--vis financial institutions: it leads to incentives on the part of financial institutions to hide the true size of their problems; it diminishes the incentives on the part of new and existing shareholders to put up capital as they are unsure about the capacity of the government to provide loss protection; and more generally undermines the confidence of depositors and investors. In sum, countries need to develop larger public war chests to deal with their problems.

Requiring government bond markets. The large size of the problem, and the demand on public resources, requires a greater capacity of the government to raise and service non-inflationary funds associated with the resolution of the troubled financial institutions and to fund the various agencies involved in the disposition of assets acquired from failed financial institutions. Dealing with the aftermath of the current crisis will thus require more developed, domestic government bond markets. To date, bond markets had not been well developed in most East Asian countries. Healthy fiscal positions meant that there was little need for a domestic government debt market. As public debt stocks are generally low, however, significant funds can be raised in most countries. In some countries, most notably Indonesia, an already stretched fiscal budget and a high external debt will make the financing of the restructuring costs in a non-inflationary way difficult.

Box: Government securities markets are urgently needed

The crisis is increasing budget deficits throughout the region, which in part are to be financed by government bonds. Furthermore, financing bank restructuring and fiscal expenditures will require additional government bonds issuance. Initially, in some countries such as Indonesia, the placement capacity of bonds with the public is limited, and it is likely that they will not trade in secondary markets. Over time it is expected they will be offered to the public, and at a later point short-term issues will be refinanced into longer maturities. East Asian governments have an opportunity to turn adversity into an opportunity by having government bond markets lead the development of corporate bond markets. Development of government bond markets can trigger changes in regulation and market practices, offer a standardized product that attracts the highest willingness to participate of all agents in the market, and establish a yield curve for corporate bonds. Further, government bonds will offer good means of supplying liquidity, currently circulating within the financial sector only, to the real sector. To develop the domestic government bond market, government should address issues such as disciplined programmatic issuance

e strategy that maintains liquidity, and ensure periodic price discovery.

Source

Source: CMD Michael Pomerleano

Macroeconomic policies need to be supportive

Fiscal

Policy. The collapse in domestic aggregate demand and the disappointing export growth suggest the need for expansionary macroeconomic policies to stimulate recovery. The pursuit of expansionary policy is constrained, however, by two key factors, namely (a) the scale of contingent liabilities including capital requirements for banking/corporate rescues alluded to above; and (b) the effect on market confidence. It is important, however, to recognize that the impact on aggregate demand of fiscal expenditures associated with bank recapitalization may be markedly different from that of other fiscal expenditures. While there are strong reasons not to focus on a balanced budget in the context of a major contraction, this is especially true if some expenditures are to address the problems in the banking system. In terms of restoring confidence, a firm macroeconomic stance is meant to signal a commitment to stability and fighting inflation. Given the strong macro-economic record of the East Asian countries, however, the need for such signals is far less than in the case of Latin American countries, which have been plagued by high rates of inflation and large government deficits in the past. Some fiscal stimulus can thus be a sensible part of the comprehensive restructuring program.

Monetary Policy. High interest rates continue to be a major contributor to corporate and financial sector distress in most of the affected East Asian countries. In contrast to countries like Japan and other, more developed countries, the external debt and financing situations have not allowed for a de-coupling of the combined financial/corporate sectors problems from monetary policy. The East Asian countries are also much more open, in terms of trade and financial transactions, than many other developing countries which have gone through financial crises, and thus have more limited room for independent monetary and exchange rate policy. High interest rates have thus been more necessary than in other situations to support exchange rates.

High

High interest rates, however, raise firms and indebted households debt-servicing burdens significantly and erode equity and asset values, leading directly and indirectly to a decline in economic activity. The indirect effect includes that of higher interest rates on capital asset values, with adverse effects on access to credit, and in turn on output and asset prices. While the impact on different firms differs markedly, even in a highly transparent economy, it would be difficult to ascertain quickly the magnitude of the effect on each individual firm; the lack of transparency in several of the countries exacerbates these problems. And the financial distress of corporates has weakened the portfolios of banks. Clearly, reducing interest rates while maintaining exchange rate stability would help reverse this vicious cycle and stimulate economic recovery.

Chart

with tradeoffs between interest and exchange rate movements on number of distressed firms for nine East Asian countries

Source: Giovanni Ferri et al.

Argu

ments appear to favor a policy promoting lower real interest rates in East Asia currently. Even so, lowering interest rates will not immediately undo the effects to date of the higher interest rates; there are hysteresis effects arising from the depletion of net worth, and the higher debt equity ratios resulting from the extended period of high interest rates. The precise mix and scope of monetary policy easing will need to be country-specific and timed appropriately. As regards instruments, in addition to open market operations and some administration of interest rates, the rates to borrowers can also be lowered through measures to reduce intermediation spreads, such as lowering or remunerating reserve requirements, reducing specific risks, etc. [?????]

Sequencing of various reforms needs to be considered carefully

General considerations. There can be little doubt that the long-term vitality of the affected East Asian economies depends upon major structural reforms, many of which are included within adjustment programs currently being pursued. However, the issue of proper sequencing is a serious one and not just related simply to administrative and political capacity for implementation. First, attempting to solve each and every problem may or may not be possible but is certainly perceived to be difficult. The resulting uncertainty whether they can or cannot be carried through is clearly detrimental to market confidence. Second, there can be genuine tradeoffs between measures to enhance long-term productivity and efficiency (e.g. through competition) and those supporting short-term recovery. Indeed, some reforms that are clearly desirable in the long term may actually impede the short-term recovery. Third, by its very nature, deep structural reform is a long and arduous process going well beyond the stroke of a pen. Credibility requires belief in the sustainability of reforms, which in turn requires commitment and coalition building. Fourth, attempting to undertake them quickly especially in the midst of a crisis and papering over difficult political issues, often lead to quick fixes which can cause problems over the longer term.

Financial sector crises provide little opportunity to reflect, however. Because of the speed with which financial sector crises often evolve, there may nevertheless be little time to reflect on the appropriate sequencing, and indeed it often seems that there is little alternative but to deal with the most pressing and immediate issues. Typically the sequencing proceeds as follows. At first, liquidity support is provided to what appears to be viable, but temporarily illiquid financial institutions. As the liquidity support becomes unviable, the financial crisis hits, maybe triggered by a foreign exchange crisis. This was the pattern in Korea and Thailand where liquidity support to weak financial institutions amounted to more than 10% of GDP before the foreign exchange crisis hit.

Clearly, the liquidity position of financial institutions represents the first line of pressure, and the process of financial sector restructuring and the underlying problems of the non-financial enterprises must, at first, take a back seat. The first phase of policy in a crisis will thus be containment, followed by bank and corporate rehabilitation. But even in dealing with the problems of the banks, faulty sequencing can greatly intensify the economic downturn as well as increasing the burden of losses that ultimately falls on the taxpayer. Of course there are many



structural policies which should always have been in place: bankruptcy laws, prudential regulations and supervision practice, quality of accounting and which cannot readily be brought on stream when the crisis strikes. Nevertheless, especially in the early stages of the crisis, when the immediate pressures fall on the central bank in provision of emergency liquidity, there are crucial choices to be made.

Yet, liquidity support involves choices of principle. These crucial immediate choices should be governed by three general principles: first, private sector decisions with lasting implications should not be based on false prices or distorting incentives; second, intangible capital in the form of information and organizational capacity should be protected so far as possible; and third, avoidable uncertainty should be minimized. Between them, these three principles can quickly translate into concrete recommendations for many practical situations, taking into account specific local circumstances.

**Stop looting**  
and improve capital at risk. An insolvent financial institution that is being looted by its managers provides an easy application of the first principle. By the time the crisis has hit, the consequences of years of regulatory inaction will be being felt and it may appear that a few more months of forbearance can add little to the problem. However, a financial institution that moves from marginally or questionably solvent to undoubted insolvency is a financial institution for which managerial and shareholder incentives have suddenly changed. They have no incentive to behave in such a way as to keep the financial institution in operation on a viable basis. Furthermore their actions will speedily drain away the financial institutions resources - including those lent to it by the central bank in the form of liquidity loans as was disastrously evidenced in Venezuela for example in 1994. In such an instance there can be little reason for delay. Prompt intervention is needed to inhibit looting, but must be done in such a way as to preserve banking capital and depositor confidence. While restoring the financial institution to full effectiveness will take some time, there is every reason to act instantly to stem the hemorrhage by restraining the manager's power to loot, perhaps by appointing a conservator if no better solution is immediately available. The cost of the financial crises was likely increased in several affected East Asian countries by the inability of authorities to stop the transfer of resources out of financial institutions which had long ago turned insolvent.

A failed bank cannot be allowed to return to normal operation without adequate capital. Furthermore, the bank's shareholders should not be indemnified against losses incurred. But these maxims need not exclude imaginative contractual arrangements in which government holds some of the capital for a transitional period, thereby allowing the banking system to return to normal operation faster than if it had to wait for new private capital to be injected. To date, most governments in affected East Asian countries have been passive in expecting that private sector solutions would be forthcoming.

Delay some, but not all structural reforms. Because a financial crisis is generally a time of retrenchment rather than expansion, the urgency of implementing some structural reforms that remove distortions may also be diminished, allowing a breathing space for banks and their enterprises whose ongoing viability and creditworthiness will be adversely affected by the reforms. Selective deferral, though not abandonment, of some reforms may be an appropriate transitional

response to the financial crisis, with the reforms to be brought back on track when the crisis is under better control. But here a subtle issue of confidence also arises: announcement of politically difficult reforms may be just what is needed to restore investor confidence in the government's capacity and determination to set economic policy on a viable course.

Do not over-hastily close or suspend, and be careful in replacing management. The second principle cautions against over-hasty closure or suspension of problem banks. Even where top management has been weak or corrupt, it will often be the case that substantial parts of the bank's operations are sound and bear value. In prioritizing intervention actions, therefore, forms of restraint such as cease and desist orders or conservatorship should generally come first. These need to be backed up by an in-depth evaluation of the management and organizational capacity of the bank in order to guide its subsequent disposition. Institutional and financial reorganization will follow: if necessary this will involve an orderly suspension or closure, though only where the bank's capacity and operations prove on inspection to bear little of merit, or where management weaknesses pervade the bank. Only a small minority of industrial country bank failures in recent years has been resolved through outright closure of the banks involved.

In a systemic case, particularly when the country was over-banked to begin with, large-scale closure might nevertheless be the best course of action. Dealing with these insolvent financial institutions may have to be pursued through wholesale approaches versus case-by-case approaches, however, and the timing of dealing with losers may have to be deferred. The management of the worst affected banks must, of course, be replaced. But for other affected banks the treatment of top managers may require a more nuanced approach. The scale of a systemic collapse may be such as to effectively exonerate many of the managers from culpability, and a doctrinaire approach to their removal may be more costly in terms of lost human capital than it gains in terms of incentive creation.

Be comprehensive. The third principle is a key one for the financial sector, but also one, which needs to be applied with great discretion. Removing uncertainty is not something that can easily be done; actions that achieve it in one country under specific circumstances may fail in another with slightly different conditions. Probably the key ingredient is the unwavering adoption by government of a coherent medium-term approach to the overall problem that spells out in sufficient detail the policy parameters that will be adopted. These will necessarily include an indication of how the losses will be allocated and absorbed, with corresponding implications for medium-term fiscal and monetary policy. Actions to protect macroeconomic stability should neither be deferred because of the vulnerability of banks; attempts to do so will be counterproductive. But nor should such actions be taken without regard to their long-term sustainability. The chances of success in long-shot attempts to reverse a currency collapse through aggressive interest rate increases must be weighed against their certain impact on borrower solvency already impaired by the losses occasioned by excessive exposure to exchange rate risk.

And credible. The establishment of credibility is at the heart of political management. Where it is lacking, the government itself will become vulnerable; conversely, achievement of a broad national cross-par

ty consensus on the overall policy approach will stabilize the political environment while restoring a healthy economy in a way that could prove to be in the longer-term interest of opposition politicians also. Without assurance that a coherent policy framework is in place, investors, domestic and foreign, will prefer to retain the flexibility or "option value" of deferring decisions that could begin to bring inactive resources back into play. Asset prices will continue to languish or decline because of the self-fulfilling fear that the worst has not yet come.

In a systemic crisis where the solvency of many banks has been put into question it will generally be unwise on confidence grounds to deal with the problem in a piecemeal fashion, addressing only the problems of a handful of "most severely affected" institutions at first. Unless the authorities' actions encompass the problems of substantially all of the financial institutions that have been placed in doubt, market uncertainty may be heightened, rather than reduced, by the initial actions. Facile approaches to delivering greater certainty will not normally work. For example, a blanket guarantee of unlimited deposit insurance may not be credible if the government's record in delivering on promises is weak, and especially if it is not clear whether or how the financial resources needed to cover prospective depositor losses are going to be mobilized. As was seen, a depositor run is easily transformed into a currency panic.

Nevertheless, and although deposit guarantees are not the only type of action that a government can take in the course of a financial crisis to help reduce uncertainty, they can be important. Of course, by reducing depositor vigilance, an open-ended standing deposit guarantee can encourage moral hazard by financial institutions managers, and as such gives rise a need for intensified prudential supervision. There is much to be said for insisting on the retention in normal times of an important tier of uninsured creditors to help multiply the watchful eyes. But in times of generalized depositor panic this goal may have to be suspended. It all depends on how widespread the deposit runs are, and whether the funds withdrawn are being retained within the domestic financial system. If depositors have lost confidence in the banking system as a whole, then a government, which has sufficient credibility to do so, will want to issue a temporary blanket guarantee. However, a "run to quality" within the domestic financial system should not trigger such a guarantee.

Be careful in the financial sector rehabilitation phase. The restructured banking system will need to be adequately capitalized and with an efficient cost structure. The removal of most of the non-performing loan portfolio from the bank's books will normally be a priority in the rehabilitation as, even if heavily written down, these bad assets will act as a drain on managerial effort and can badly skew incentives. A clean break with the past can also help rebuild confidence in the failed banks. Bank mergers can help, especially in the context of financial and institutional downsizing, but only where they make commercial sense to the acquirer. Merging two weak banks generally results in greater weakness as well as greater size. Finally, undue haste in re-privatizing intervened banks, or undue eagerness to maximize the initial revenues from such privatization without regard to the incentive structure that is being created will only store up problems for the future, as was evidenced by the experience of Mexico in the early 1990s and Chile in the late 1970s.

To summarize, some of the key lessons for sequencing or prioritization in the containment phase of a financial crisis are in three areas. The mechanisms under which support is provided to financial institutions need be sufficiently linked to progress in operational restructuring of the banks themselves. Otherwise, liquidity support and recapitalization are wasted. The timing of dealing with bad financial institutions is often premature and their restructuring takes often too much preoccupation, both in terms of commitment of public funds and attention, at the expense of only limited support to good financial institutions. Dealing with losers may have to be deferred. The lessons are thus negative ones: don't provide liquidity to a bank until you are satisfied that adequate governance is in place; don't close a bank in the middle of a systemic crisis until a credible system-wide policy is in place; don't announce a blanket deposit guarantee if depositors are merely running to quality within the system; don't act aggressively except in the context of a coherent and viable overall contingency plan.

And coordinate financial and corporate restructuring well. Rehabilitation of banks and non-financial corporates can in principle be considered separately. When insolvency in the non-financial corporate sector is widespread, as was the case in many transition economies, and has emerged in the East Asian crisis, financial and organizational rehabilitation of the banks will, however, not be enough to ensure normal functioning of the financial sector. Indeed, this is an especially risky time for newly re-capitalized banks that have the financial resources to resume lending, and are confronted with demands for credit from un-rehabilitated non-financial enterprises. How are the banks to survive without a commercial clientele? How are they to resist what may be strong political pressures to lend to key enterprises which are insolvent?

Typically in systemic cases, the restructuring of banks and corporates has been poorly integrated. In case of Mexico, 1995, for example, there were very little linkages between corporate restructuring and bank recapitalization. Bad loans were transferred to an AMC (FOBAPROA), but this institution undertook little restructuring, in part as the Mexican bankruptcy systems is very cumbersome, and was even reluctant to sell its loans to investors. As a result, the size of the non-performing assets under public management ballooned from .. billion in 1995 to \$64 billion in 1998, or 15% of GDP. That Mexico was still able to recover relatively quickly had more to do with its closeness to and recent integration with an export major market, the US. The fact that domestic financial intermediation was relatively low and firms were able to obtain financing from foreign sources also mitigated the negative effects of its financial sector crisis.

Evidence from transition economies shows that it is where the non-financial corporate sector has been put on a sound basis, usually involving privatization, that the financial sector has been able to establish and retain viability. In the end, banks in transition economies, however, did not actively restructure enterprises; it was a hard budget constraint and privatization that encouraged the necessary restructuring. In other cases, notably Hungary, delay in restructuring of non-financial corporates has led to a need for repeated recapitalizations of the banking system. In contrast, Chile in the early 1980s, after some failed attempts, adopted a comprehensive, integrated bank and corporate restructuring approach (see box).



## Box: How the 1981-83 Chilean Banking

### Crisis was Handled

The banking crisis in Chile in 1981-83 was widespread, representing about 60 percent of the banking systems total portfolio. The crisis arose because of macroeconomic problems and was exacerbated by unsound financial practices. After an initially delayed reaction, actions were even pro-cyclical for a time, the government adopted in 1984 an aggressive and comprehensive approach. Depending on the level of solvency, it chose to liquidate some institutions and rehabilitate others. Altogether, the government liquidated 8 banks (of the 14 taken over and 26 in the system) and 8 finance companies (of the 8 taken over and 17 in the system); with mergers, this reduced the number of banks by one-third and the number of finance companies by two-thirds. The government used two types of mechanisms to rehabilitate banks. One type was aimed at improving the borrowers capacity to repay loans to the banks. This mainly consisted of across the board debt reschedulings, for corporates and consumers, and coverage for exchange rate losses, covering about 25 percent of the banking systems total loan portfolio. The other was aimed at rebuilding the capital base of the banking system. This mainly included purchases by the central bank of non-performing loans, with existing shareholders obligated to repurchase those loans from future profits, and recapitalization and subsequent sales of intervened banks to small investors, using a variety of credit facilities and subsidies to encourage them to buy.

The government also strengthened banking supervision by improving loan portfolio analysis, including introducing an early warning system, and increasing the transparency of financial transactions, including through requiring that banks be subject to two private ratings per year and the timely publication of information on the financial condition of banks, with significant penalties for non-compliance. Various forms of forbearance were used in the initial phase of the crisis.

The breakup of highly indebted conglomerates, closure of non-viable firms, and re-privatization aided corporate restructuring. In the process, ownership was de-concentrated by selling shares using a variety of instruments to the general population. To avoid the repeat of insider lending, lending by financial institutions to owners was prohibited and measures were taken to increase equity bases, including through the further development of the private pension funds. State enterprises were privatized in a second stage, over the 1986-1988 period. Foreign creditors were involved through debt-for-equity swap schemes.

Based on Larrain, 1989, Sheng, 1996, and presentations by Rolf Lders and Hernn Bchi.

The lesson for East Asia is not only in the urgency of proceeding with corporate restructuring, but also has implications for sequencing. There is a need for bank supervisors to be especially vigilant in regard to the conduct of the newly rehabilitated banks. A probationary period for recapitalized banks should be in place while widespread corporate insolvency persists. It will, for example, be appropriate to prolong conservatorship of banks that are being rehabilitated until the financial condition of the corporate sector has improved. If sound lending opportunities are not available in this phase, wholesale deposit facilities offered by the central bank can ensure that the banks can continue to mobilize domestic resources on a profitable basis. The typically long length of the more intensive process of supervision of banks is quite long.

[[ Summarizing {cross-country experiences and best practice lessons: what matters most? Why does it often go wrong (e.g. recapitalization of banks)?; what is a good/best practice example (Chile on bank restructuring; Poland (?) on the framework for corporate restructuring, others?);} ]]]]

## 5. Restructuring options/tools available for East Asia

The above has laid out some of the measures

already put in place in affected East Asian countries and highlighted some measures which could be intensified. These measures are, however, mainly aimed at short-run stabilization, facilitating flow solutions to corporate and financial sector restructuring, and restarting credit flows to get the economy going again. Provided that the framework processes, institutions, vision, sequencing, links is developed, short-run interventions are undertaken, and some complementary reforms are in place, choices next need to be made regarding the models/tools to undertake the necessary integrated and comprehensive financial and corporate sectors restructuring which will achieve long-lasting solutions. There are no cookie cut answers, however, and many options are available. Starting point in East Asia has to be the design of the most efficient way to workout distressed corporates, as they will generate the economic growth. This will have to be done largely through voluntary (i.e., out of court) mechanisms and involve stock approaches. Other choices are less clear, however, and involve a number of dimensions: segregation of assets in distress; how to arrange loan workouts; necessary mechanisms for public support; when to recapitalize financial institutions; and assigning the lead agent for corporate restructuring (see further De Juan, 1998).

Segregation of assets in distress. Assets to be worked out can be left in the financial institutions, intermingled with performing assets. This is probably sensible for small and medium size loans since existing lending relationships will entail information valuable for workouts. Segregation will, however, most often be necessary, for other assets, especially large, complex loans. Not only are the skills for restructuring such loans very different from skills used for new lending, it will also not be advisable to make the same bank officer who made the (now) distressed loan in the first place also responsible for restructuring it. At least, separate workout units should be established to deal with these loans. This way, greater clarity can be created internally and vis-à-vis outside investors, appropriate institutional frameworks can be created within the bank (including bringing in (foreign) technical assistance and know-how), and incentives can be specifically tailored for management of this class of assets (for example, through separate compensation and performance schemes).

Box: Workout options. Segregation/non-segregation of assets: bad banks versus internal workout units versus other options. Lessons from industrial and developing countries. Ruth Neynes or Laura Ard or other SFO-staff.

### Segregation

It may also be necessary in case government support is being provided. In case of loss-sharing support (see below), for example, it will be important to separate the pool of loans supported by the arrangement from other loans to be able to account properly for recoveries and losses on this class of loans. It will also be necessary to prohibit the bank from making new loans to the same borrower

r (or any connected party) outside of this pool. Otherwise, there will be an incentive for the bank to extend new loans to the same borrower on which the bank will recover more at the expense of larger losses on the loans under the loss-sharing arrangement. Also, if the loss-sharing arrangement is for a limited period of time, it will be important to ensure that banks do not engage in excessive write-offs during the loss-sharing period followed by reversals of write-offs afterwards, as that would provide a (further) subsidy to the bank.

How to a

range loan workouts? A flexible approach is likely needed in dealing with the assets of assisted or failed financial institutions in order to obtain the greatest potential recovery from troubled assets. Unbundling the various components of a troubled bank will reduce the ultimate cost to the government when the price paid for a clean bank and a separate bundle of troubled assets exceeds the sale price of the whole bank. Further, forming pools of homogeneous assets from different banks may facilitate their sale (for example, through securitizing real estate loans from various financial institutions). In cases where the management and lending functions of the intervened bank are weak or where the intervened institution is found to have engaged in insider lending and excessive lending to insolvent companies, removing assets can allow their value to be protected from wouldbe looters. At the same time, a loss of value may result when assets are transferred as banks have informational capital about the borrowers.

And incentives for recovery and workout may be altered when transferring assets to a third party.

Three basic issues therefore need to be decided when determining the optimal workout arrangements for loans and other assets. (1) should distressed assets be managed in private hands or under government control; (2) should they be centralized and managed in one location or decentralized; and (3) should they be sold rapidly or more slowly. There are no clearly preferred answers to these questions. The markets for clean banks, pools of troubled assets, and whole banks are different within countries and markedly so among countries. And the institutional capacity of different agents differs widely among countries.

Government versus private sector. The government can play different roles in the workout of distressed assets. It can solely provide public resources and set the framework and let private agents own and try to work out the distressed loans. In general, private market solutions are to be preferred and should be adopted wherever feasible (with the government assisting in assuming some of the losses). Private institutions take different approaches when confronted with large volumes of problem loans. Typically, banks will start with segregating their distressed assets from their performing assets. Some institutions will then sell blocks of problem loans to third parties that have expertise in collections. Others will expand their internal workout units. Less frequently, affiliated but separately capitalized "bad banks" are created. The bad banks could then be managed by the old shareholders of the good bank, in collaboration with other investors, or be spun off to new investors. Or, the government can try to manage some of the distressed assets itself. No one strategy is necessarily the best. Countries like Sweden, Norway and Spain have adopted variations of the internal workout options, while in the US the RTC was established solely for the purpose of receiving, managing and selling bad assets. Assets that are privately managed under appropriate loss and gainsharing incentives are, however, believed to yield higher returns than those that are publicly held as

long as the necessary skills are available in the private sector.

#### Should Loans

Workouts be Decentralized or Centralized? The government can solely provide public resources and allow for decentralized workouts. Or it can take over bad assets from various financial institutions and centralize the management in one (or more) institution. This centralized governmental unit can be a separate asset management company (AMC), be a part of a restructuring agency, or be handled under the deposit insurance function. Recovery efforts on financial assets that are held centrally can benefit from economies of scale, i.e., the centralization of management, workout skills and application of information technology, and from allowing the securitization of a larger pool of assets (see box). An AMC-type structure can be fast and create clarity as it segregates bad loans into a new agency. A centralized unit can also leverage its resources and focus on its primary goal of returning assets to the private sector.

#### BOX: Securitization

of distressed property: REITS.

The disposition of property loans is one of the biggest challenges facing the banking system and regulators in Asian countries. A Real Estate Investment Trust (REIT), a mutual fund or unit trust that invests in tangible real estate investments, can help. REITs tend to have integrated management and have significant management ownership. Tax treatment provides for a pass-through entity that is exempt from corporate taxes. The REIT concept has several advantages. First, it gives investors a diversified real estate holdings, and tax-neutrality. Further, it can create a secondary liquid market for illiquid long-term investments in real estate. Finally, it establishes a benchmark in the capital markets, and offers a transmission mechanism for prices and interest rates, and thereby imposes discipline on the real estate industry. REITs can mobilize equity (in the US, in 1993, initial public offerings of over \$9 billion in equity represented 22% of all IPOs, and a total of over \$15 billion has been raised by REITs to date, 90% of which equity).

With

the property market illiquid, and only 41% of the mortgages current, Thailand moved to establish such investment vehicles. Acknowledging that fresh (and possibly foreign) funds will be needed to revitalize the real estate markets, the SEC authorized recently seven property funds, with another 90 applications pending. Property funds also enjoy favorable tax treatment, including exemptions from corporate income tax and a possible reduction in property transfer fees. Further, the Thai Board of Investments is liberalizing foreign ownership and funds will participate in the mortgage auctions of the FRA.

#### A centralized approach

has risks as well. The transfer of loans breaks the links between banks and corporates, links that may have positive value given banks' privileged access to information. Large transfers without involvement of banks in the restructuring itself may thus create loss of value. Transfers can create its own legal complications, such as in Thailand where the FRA, responsible for disposing assets, does not have the legal authority to restructure loans, which impedes its capacity to sell off assets (in part to the Thai AMC). Also, enterprise restructuring often involves some new lending in addition to debt restructuring, while a non-bank entity like an AMC may not have the capacity to lend. Most importantly, the incentives of a government-owned agency to restructure corporates can be poor. Even though private managers could in principle run the AMC and various



incentive schemes (performance contracts etc.) could be built in, there remains the risk of poor management.

While the experience of Sweden is rightly seen as a model to be emulated (see box), success there depended on a substantially depoliticized process and a single-minded goal of value maximization. It also benefited from strong institutional underpinnings in the form of accounting and legal framework. The successful experience with AMC's in other developed countries, such as the US RTC, may neither be replicable in East Asia. For one, the size of the problem in these cases was small, less than 3% of GDP in case of the US. Second, the capital markets and other financial markets in these countries were much better developed, thus allowing a more rapid disposal of assets, and well-qualified personnel was in large supply. Thirdly, the nature of the distressed assets was often different. In most cases, the assets taken over by the RTC were commercial real estate. The economic loss of value from poor management and weak workout for commercial real estate is likely much less than that for complex corporates.

Box: Asset Management Companies: Keys to Sweden's success

The approach adopted by Sweden to the crisis of bank insolvency, which hit it during the 1980s, aimed at the maximum transparency and disclosures of the situation. For instance: accurate mark-to-market valuation of assets and strict rules for declaring loan losses were enforced. Reflecting the distinct functions of restructuring banks and dealing with the bad assets, the authorities established a bank-restructuring agency (BRA) to perform the first function as well as a number of separate asset management companies (AMCs) to deal with the bad loans. The tasks of the BRA included assessing needs and providing financial support to banks and depositors, as well as facilitating structural changes such as mergers. While its mandate did extend to selling the whole portfolio of a bank to facilitate a quick merger, it was not to be involved in sales of assets on a piecemeal basis that would have involved a complication of its role and an enlargement of its operations. In contrast, the asset management companies had the task of converting loans into assets, restructuring them into easily saleable forms and then selling them. By separating the asset management company from the normal structure of the originating bank, the AMC avoided the risk that bank management would find most of their time and energies devoted to dealing with the problem of the past instead of the forward-looking ongoing business of the bank. At the same time sufficient problem assets were left with the bank to ensure both that it retained a loan recovery capability and that it did not gain an unfair competitive advantage in the market.

By establishing a distinct AMC under public ownership, but with the unambiguous goal of value maximization, the authorities were able to limit political interference and at the same time allow the state to enjoy the benefits of better-than-expected recovery.

By transferring assets to the AMC at a realistic valuation and by structuring appropriately individual incentives for the AMC's key staff a positive environment conducive to prompt and effective recovery was created. Sorting and grouping assets into homogenous sub-groups allowing the benefits of restructuring specialization enhanced this. In constructing saleable assets from the loan claims, it was important to establish a reputation for fairness, which helped achieve viable financial restructuring by agreement, rather than having to rely on costly court proceedings, though the credible threat of such proceedings will often have been a factor. The asset acquired as a result of these negotiations was

s often susceptible to improvement in the hands of the AMC acting as a "company doctor". A rising property and stock market made the final stage of the Swedish operation, namely dismantling of the AMCs through sale of the enhanced assets, both quicker and more profitable than had been anticipated.

In other countries,

recovery rates have often been disappointing. Most countries do not start with the advantages of Sweden with its strong legal and market institutions and the wealth of accounting, financial and management skills. But too often the goals of the loan recovery agency from Mexico to the Philippines to Senegal have been muddled by a variety of political considerations.

Source: Draws on Gran L

ind, "The Use of Asset Management Corporations in the Swedish Crisis", paper presented at EDI Seminar, Singapore, May 1998.

In general, there have been more failures with AMCs than successes. Experiences elsewhere, particularly in countries with weaker institutions, suggests that many a time such an agency sits on its loans, often in fear to antagonize the powers to be (which often contributed to the bad loans). The AMC will end up being passive and not forcing the necessary operational restructuring of corporates, and largely just rescheduling claims. In case of Mexico, and many transition economies, which involved more complex assets, centralization in the end delayed the corporate restructuring. Evidence so far suggests that this tendency is already present in some East Asian countries.

The successful implementation of a publicly owned asset management company approach thus requires tackling the issues of management incentives.

If a centralized unit is to play a role, it must be set up quickly with a clear pricing mechanism for the transfer of assets. It must be well funded, have authority to act and an incentive to place assets in the private market as quickly as possible while recognizing that rapid sales may have a negative impact on the value of similar assets for a period of time. The centralized unit should not be established for the purpose of hiding the real cost of the losses. Finally, it must be established with a strong mandate and a short life, 3 to 5 years maximum.

The best speed of selling assets can depend on the type of assets.

Selling assets rapidly establishes a floor for prices that may promote a speedier recovery from the economic crisis. On the other hand, warehousing problem assets in the hopes of obtaining higher values for them may prevent prices from plummeting, but the overhang of the warehoused assets may impede price discovery, market recovery and prolong the recession. Much depends on the development of financial markets and the supply of new capital willing to buy assets. Choices on the speed of selling assets may also differ by type of assets. While rapid sales can lead to depressed real estate prices, this need not be an economic loss of value as the rate of depreciation of commercial real estate is more independent of management. This may not be the case for other type of assets. And the speed of selling assets will determine the distribution of gains and losses involved in financial reform as those with cash at hand will be king.

These

choices give rise to a number of options. For example, assets might initially be centralized under government control but rapidly sold into the private sector. Alternatively, the government might decentralize their management under a

number of "bad bank" receiverships and adopt a slower, more orderly disposition of problem loans and real property. The appropriate choice depends on a number of factors that include the: ability of banks and other private entities to effect collections; level of government assistance available; size of the intervened institutions; market demand for problem assets; volume of assets relative to the capacity of the market to absorb them; types of assets and their homogeneity and liquidity; pool of talent available to work the assets and whether there is a need to economize on limited resources; necessity (or desirability) of selling the assets rather than restructuring them; presence of loan syndications; strategies adopted for resolving the intervened institutions; ability of the receiver to gain control of collateral and the effectiveness of bankruptcy procedures; and depth and transparency of markets and their ability to facilitate price discovery.

What type of mechanisms for public support to use? The systemic nature of the problem means that schemes are necessary for making public money available for recapitalization of banks otherwise unable to raise sufficient capital from private sources. Since banks owners and managers have been in great part responsible for their weak loan values, and given the large differences in capital positions among financial institutions, support can, however, not amount to a form of blanket recapitalization, with all its perverse incentive problems. Support should discriminate with respect to both the quality of assets and the causes for the weak loan values. Banks will thus need to meet specific criteria to be able to access the provision of government funds and support should not be available to nonviable banks, which should be closed promptly. At the same time, the support program will have to somewhat of a wholesale nature, given the difficulty to do quickly in the current environment a proper evaluation of the quality of assets and the degree of management contributing to the capital losses. As much as possible the scheme will have to use private sector information.

The use of public money in recapitalizing banks must also be seen as a last option and every possible effort should be made to force banks to seek private capital. However, that process, which has thus far been only very partially effective in East Asian countries, is unlikely to attract sufficient private capital without government assistance. New and existing shareholders, including foreign investors, are reluctant to provide new capital unless there is some clarity on what the government is willing to do in terms of taking bad loans off the books. The scheme should therefore aim to make private investments in banks more attractive.

The provisions of the scheme should also be broad enough to address the recapitalization needs of various financial institutions on a generally uniform basis and should be made known to all potential investors. For potentially viable banks, government support should be provided where it will be most effective in keeping the banking system sound and functioning. Moreover, the scheme should promote improved management capability and technological know how in banks. That would mean confining financial support to the core banking system that consists of the major national and regional commercial banks. Other banks and financial institutions should be dealt with in the preferred manner under prompt corrective action that is closed, if necessary.

In some cases, the governments budget constraint may also have a major impact on the

amount of support that can be provided. In cases of limited available public support, it may be better to provide adequate assistance to a smaller number of banks than partial assistance to all banks that qualify for assistance, for inadequate recapitalization tends to result in a second round of failures later on. A general principle would be that all major banks that are viable should be able to request recapitalization to minimum standards during a specified period of time. The agency in charge of the restructuring agency needs clear legal authority, with accompanying accountability, to make this determination. Lacking clear legal authority to discriminate in its evaluation of the public interest, the restructuring agency may otherwise come under public and political pressure to extend public aid beyond the core banking system.

There are a number of ways that the government can help the problems in banks balance sheets. These include rehabilitating assets, loss-sharing, reducing liabilities, and injecting capital (see box). The terms under which government support should be provided are mostly a function of the size of the undercapitalization and the desired burden sharing (see below). In all cases, the most important step is to require an assisted bank to form an acceptable business plan that encompasses both capital restoration and operational restructuring to reduce costs and enhance revenues without taking on additional risks.

Box: Different forms of support to banks: Options.

Asset rehabilitation involves the swap of impaired assets for cash or bonds. These swaps will not raise banks net worth unless the operation is done at above market prices (possibly at book value), implying a subsidy to banks and a violation of transparency. Nevertheless, even a swap at market prices enhances capital adequacy, liquidity, and the ability to make loans and can reduce funding costs. Riskweighted capital ratios (RWCRs) improve because the asset swap generally replaces risky loans with low risk investments, such as government bonds or cash. While providing benefits to the troubled bank, the government needs to consider the overall cost of the transaction, as the expenses associated with disposing of the troubled assets may be high.

Under a loss sharing arrangement on (a certain part of) bank assets, the bank would continue to manage the loans and try to collect on them, but would be compensated for a part of the losses. Many type of loss sharing are possible. It could be proportional, or the bank could take the first losses and the government could cover on a sliding scale more of subsequent losses, e.g., disaster insurance. The loss-sharing could be for a limited period of time only, e.g., three to five years, after which banks will be held to full provisioning and other standards. Put-back options, interest guarantees, and options to buy could be used to structure the loss sharing. The pool of loans to be covered and loss-sharing arrangements could be based on an (aggregate) assessment of the distribution of expected losses under different economic scenarios for each sector or pool of assets. For example, commercial real estate loans may be subject to a more favorable loss-sharing arrangement than residential loans, with corporate loans in between. Banks would of course be allowed to adjust classification and provisioning of loans in line with received government support.

Liability reductions involve writing down creditors claims, which improves the capital to assets ratios and potential profitability, without raising additional equity. While some Asian countries in crisis have given creditors a general guarantee, it may still be possible to



o write down the claims of common and preferred shareholders and owners of subordinated debt.

Equity purchases by government, subordinated debt, or unrequited injections of cash or bonds (either negotiable or nonnegotiable) will also immediately increase net worth, improve the capital ratios, liquidity, and potential profitability. If asset values and corporate earnings are temporarily low, but will recover as the economy strengthens, support through (temporary) government capital injections may make sense. This would follow the model of the Resolution Finance Corporation (RFC) in the 1930s in the US, where a systemic economic collapse threatened banks (see ..., 1992). Temporary government support through purchases of preferred stock on a sharing basis then allowed for viable banks to survive. Self-selection incentives were built in, as private shareholders needed to come up with their own capital. But the success then lied with that the cause of weak asset values was largely outside the responsibility of banks themselves, and that many banks were solvent conditional on the overall economy improving. Incentives to gamble were low, partly as deposit insurance coverage was low and as opportunities to earn large profits at high risk were probably few and far between. Equity purchases by the government can be of common stock or of preferred stock. If the latter is used, the government might delay dividends for some period to support the banks income. Options to put-back private equity stakes to the government and options to buy the government stake could be used to balance burden sharing and incentives considerations. Subordinated debt that is convertible into equity in the event of failure to repurchase within a specified time or financial or managerial incapacity has the advantage that it may protect the government from the banks potential inability to service the debt by allowing the government to intervene. Such contingent clauses also provide an effective incentive to ownership and management to expedite their efforts to rehabilitate the bank. The government can finance equity or subordinated purchases or cash injections by selling government paper directly or it may opt to inject bonds, which can in turn be sold by banks for cash. The main drawback of unrequited cash or bond injections is of course that the government does not establish any ownership or control rights.

Granting government loans or

placing deposits will also improve bank liquidity and provide an opportunity for the bank to buy unimpaired assets. However, this does not immediately increase capital or improve capital ratios because assets and liabilities increase by the same amount (it may even lower capital ratios if risky assets are bought).

Moreover, unless the institution has new, fit and proper owners and managers or is under very close supervision, there is a danger that the recipient will put the funds at risk by investing them unwisely in risky assets as it gambles for recovery.

Source: SFO/MAE

Burden sharing by banks shareholders, and other creditors, is necessary. A countrys legal system establishes the seniority of claims and the order in which they can be written off, with equity claims listed first. Public sector capital injections should also not be a gift that detracts from the incentive structure by bailing out existing shareholders. Thus, where a bank is still solvent, legal rules and incentivecompatibility would suggest government capital should dilute, but not completely eliminate, existing shareholders rights. Correspondingly, where the bank is insolvent, claims of shareholders and subordinated debt holders should be written down completely before government capital is injected, unless the government is responsible for the banks losses. As noted, in most comprehensive financial restructurings shareholder

s and non-depositor creditors, and sometimes depositors as for example, in 1995 in Argentina have mainly sustained the losses.

However, such incentive purity may not be feasible, particularly in systemic cases, as it might entail closing most of the banking system. It may be necessary to allow existing shareholders to retain some partial ownership rights to avoid closing a large part of the banking system. This might also be necessary in order to obtain existing shareholders complicity/cooperation, and to avoid timeconsuming and costly legal wrangles. This should be accompanied, however, by a requirement of adequate burden sharing. And, since if shareholders are partially protected other noninsured creditors may demand similar protection, the government needs to determine its policy with respect to these creditors as well.

The degree of burden sharing will be country-specific. Countries circumstances and political factors will dictate the preferred degree of burden sharing. In some countries, banks may be controlled by shareholders which possibly have access to fresh capital and which in any case may have a stake in maintaining some control in the bank. In such cases, existing shareholders may be usefully asked for new capital. In these circumstances, the government might require, where feasible, that existing shareholders inject new capital, perhaps in proportion to the governments contribution. In Thailand, the modalities of government support center on the degree of burden sharing with existing shareholders. Modalities under discussion include a pro-rata scheme where losses are shared and government injects new, Tier 2 capital (to be updated by August 31). In Mexico, private shareholders were also asked to put up capital in proportion to support provided by the government. Of course, the capital put up needs to be genuine, and can not be borrowed, for example, from other or the same financial institution. In the end, the capital provided by shareholders in Mexico in the privatization of banks in the late 1980s, for example, was often borrowed. The government should therefore identify, screen and monitor the source of capital and enforce compliance with this requirement.

In other countries, share ownership may be more diffused and no particular party can be called upon to provide new capital. In Korea, where shareholder ownership is more diffuse and domestic source of capital often face conflicts, the government has been discussing with advisors and interested foreign commercial banks the nature and amount of support necessary to be able to sell two intervened banks. Other mechanisms are under discussion for three other, large commercial banks. In yet other countries, such as Indonesia, existing ownership in many banks suffers from long-standing connections between banks and corporates that have undermined the market-based allocation of resources, making existing, controlling shareholders less attractive long-run owners. Whatever the form of government support may entail, it will be important to ensure that the parameters for support are clear and announced, and available on an equal basis to all interested parties, both existing and new shareholders, foreign and domestic.

Many tools can be used to achieve the desired burden sharing. The many tools to provide support to banks can each involve different degrees of burden sharing. Loss sharing arrangement could only be made available, for example, provided the private owners inject capital in a certain ratio to the support provided. This would allow for some of the burden sharing and, equally impor

tant, would allow for some self-selection. In particular, those banks which do not choose to participate at the terms offered should either be sound or, more likely, have weak portfolios with private owners therefore not willing to put up new capital and would be likely candidates for closure. Burden sharing can also be accomplished through the pricing at which assets will be taken over from banks. In Korea, loans were initially taken over from banks by KAMCO at the face value of loans minus provisions. To the extent banks underprovisioned, which was most likely the case, the government provided them with a transfer.

## C

Contingent arrangements are also possible. Distressed assets could be taken over by the government, but the banks continue to be responsible for the collecting on loans. The structure could be a substitution of impaired loans for a government bond, which would thus recapitalize the banks. The government would have a claim on the bank for any portion uncollected on the loans. This off-balance sheet claim could be capitalized at a market interest rate, or at a below market rate to provide banks with income support. The obligation to pay on this obligation could fall on the old shareholders, i.e., they would not receive any dividends until this obligation had been repaid. The obligation would, of course, have to be treated favorably for capital adequacy purposes since otherwise there would not be any capital support. In this, and with other constructions, it may also be necessary to separate the old and new equity claims. This was used in Chile, where distressed loans were transferred to the central bank. But, in exchange the central bank had a claim on the bank which had to be repaid by the existing shareholders of the bank (these shareholders did not receive dividends until the claim was repaid; in some cases, repayment is still ongoing). The payments due under this obligation depended on the recovery of the loans, thus shifting the burden back to old shareholders.

In Mexico, the shareholders

were given first option to bring in additional capital when a bank became undercapitalized, with the government offering to take out 2 peso worth of non-performing loans for every additional 1 peso of capital injected by shareholders. When shareholders were not able to bring in additional capital, the government recapitalized the bank with mandatorily convertible bonds, taking over the corresponding share of the bank until it could be sold to a new buyer and existing shareholders completely diluted. The recapitalized banks were asked to administer the non-performing loans, with a loss sharing formula of 3:1, i.e., the bank would take 25% and the government (through the agency FOBAPROA) 75% of all losses on the non-recovery of non-performing loans. This was to preserve the incentive for banks to manage and recover on their non-performing loans, even though the government bought them out. Banks could work out the debts of troubled but viable corporations on a voluntary basis under the so-called UCABE scheme.

As noted, in the end the results have not been satisfactory as non-performing claims in FOBAPROA have continued to pile up it is now the largest holder of financial assets in Mexico, but provides no financial intermediation and corporations have not been restructured sufficiently.

Burden-sharing of losses by corpo

rates. Given the wide diversity of corporates, it is difficult to generalize the degree of burden sharing which can or should be expected from an individual corporate. It is clear, however, that while many corporates may be technically and economically insolvent, it will not necessarily be economically efficient, nor political acceptable, to have all existing shareholders completely diluted.

With the recapitalization of the banks, and thus substantial government ownership of the financial sector, and given the large-scale distress in the corporate sector, this would amount to nationalization of large parts of the economies. The need to leave to some degree existing corporate shareholders in place is all the more so the case given the significant strength of corporates in East Asia, where management of the real side of business has been relatively well. Wiping out completely existing shareholders would imply a great loss of value. Significant dilution, to be determined on a case by case basis, however, should be the objective to bring in new shareholders, whether domestic or foreign, and, where necessary, new management.

Capital markets can help achieve better debt-equity balances. Deeper capital markets will create more balanced financial systems and improve corporate financing and corporate governance. A larger role for capital markets will also reflect the key trends in the international financial marketplace (including massive financial innovation through capital markets, widespread disintermediation of traditional banks, convergence of listing and other practices etc.). Although there are many challenges, several immediate priorities lie with bond markets development, regulatory and enforcement capacity, and improving risk management. Securitization of distressed assets can also help develop capital markets (see box).

Starting with government bonds. Efforts need to develop supporting market institutions, issuers, investors, and instruments. Also the creation of market making network, credit agencies, and development of a mutual funds industry are necessary. Developing a viable government bond markets can trigger the necessary regulatory and market practices changes, and also lead to a yield curve for corporate bonds. By offering standardized government bonds, with large size and appeal to all market participants, and of fungible securities of different tenors, a benchmark yield curve can emerge. This can be complemented by other instruments, include securitization and derivatives, which will further promote risk pooling and enhance liquidity.

Requiring regulatory changes, and better institutional investors, and improved risk management. Globally, there has been a convergence of practices regarding disclosure, listing requirements, etc., as reflected in work undertaken by regulators (IOSCO), as well as stock exchanges and investors. There is also increasing overlap between banks and capital markets activities, and globally laws and regulations applicable to banks, securities, and investment funds have been substantially amended. In the US, for example, regulators have broadened the range of permissible activities for bank holding companies with securities subsidiaries. In this environment, East Asian countries have to focus more on consolidated supervision. An increase in mandatory disclosure (broadly defined to include timely disclosure of material information) coupled with imposition of substantive civil or criminal sanctions, and enforcement of statutory provisions on efficient corporate disclosures by listed firms is also needed. Institutional investors collective investment vehicles (mutual funds or unit trusts), insurance companies and pension funds can lead to improved research, reduced transaction and management costs, and enhanced liquidity. Institutional investors are also likely to improve allocative efficiency, and corporate governance. There is considerable scope for further growth of institutional investors in East Asia. Regulators can help by establishing a well-defined regulatory framework that will enhance their appeal to the investing public [more specificity]. The recent



crisis has also documented the absence of effective risk management practices in Asia. Financial integration is leading to new risk exposure, and financial liberalization is leading to proliferation of financial products. East Asian corporations and banks need to manage risk conforming to international standards and best practices, including through using derivative products.

And improved corporate governance. The current state of corporate governance in Asia is inadequate. Anecdotal reports suggest instances of self-dealing and abuse. Legal and corporate governance measures that protect equity and debt investors against expropriation and good enforcement mechanisms are lacking. These deficiencies in corporate law norms and concentration of share-ownership combine to discourage minority shareholders activism, responsiveness to capital market signals, and undermine capital markets development. Improvements in the protection of minority shareholders include an enhanced role for the Board of Directors. Activist Boards can exert independent business judgment, and be a focal point for conduct of corporate affairs and governance including, monitoring management on behalf of shareholders. Enhancing the role of independent directors, and the requirements prescribed for the board can be achieved quickly without dramatic changes in the legal system, and be done through changes in listing requirements (for instance, Indonesia does not require independent directors for listing), supplemented by statutory legal remedies (civil and criminal penalties). (To be expanded/verified with material by Mike Lubrano/IFC)

Enhance the role of foreign investors. Enhancing the role of foreign investment in the economy has been a stated objective in all affected East Asian countries. Foreign investment can provide much needed expertise and new capital, which is urgently needed, especially in the financial sectors, where most East Asian countries had significant barriers (Claessens and Glaessner, 1998). So far, there has been considerable liberalization of foreign direct investment and portfolio flows, both equity and fixed-income instruments as well as money markets, most notably in Korea. Investment in both the financial sector and the corporate sector has been liberalized, albeit with some limitations in some countries. Following this liberalization, there has been a reasonable amount of foreign capital inflow since late 1997, mainly in the first quarter of 1998 (?). But foreign investment in the financial sector is still small, in spite of the large benefits (see box). More recently, all types of foreign investors have been cautious.

#### Box: Foreign Investment in the Financial Sector

Some countries that have experienced large shocks (triggered in part by macro and micro distortions) have opened up quickly to foreign financial firms and have benefited from foreign entry. Foreign banks have, for example, played an important role in the restructuring of banking systems. In Mexico and Venezuela foreign banks have emerged as key players in efforts to recapitalize banks; and in Argentina foreign banks have brought in new capital. Foreign banks now play a significant role in many Latin American countries (see chart). In Mexico, for example, the twelve largest banks were merged into seven banks and all but one (check) attracted significant stakes of foreign banks. In transition economies, cooperation between foreign and domestic banks has helped to improve the capacity of local institutions. In Poland and Hungary, for example, foreign banks have brought in very useful know-how and capital.

These experiences suggest that the benefits of internationalization can quickly overcome various up-front costs and risks, including reduction in franchise values for existing financial institutions. Foreign banks have also proven to be a source of stable funding in the face of adverse shocks. In Argentina but also in Mexico in late 1994 and early 1995, foreign banks were able to maintain access to offshore funding while domestic banks experienced strains.

Source: World Bank, 1997.

The prospects of increased foreign inflows with associated benefits nevertheless raise the issues of whether countries should aim to maintain some sovereign control over their economies, through golden shares, and limiting voting shares. Such considerations should be balanced, however, with the (increased) reluctance on the part of foreign investors to commit new capital without significant assurances on control over management. And in fact, most countries have progressively moved in the last half-year to more liberal regimes.

Who will lead the corporate restructuring? Choices are banks and other financial institutions, other corporate, government, and existing or new corporate shareholders, whether foreign or domestic. Determining the best agent will likely require a differentiation among types of corporates. Small firms can likely be restructured by banks and other financial institutions; large, complex corporates might require a joint effort of the government and financial institutions; some other claims may need to be restructured solely by the government or a government agency. While the capital contribution of existing or new shareholders is likely to be minimal in many cases, they can be important agents in determining the operational restructuring. Other corporates will help force restructuring through withholding inter-firm credit and supplies. The following matrix tries to capture these choices.

Table...: Classification of possible agents of change  
Difficulty of restructuring

Size of corporates/

Loans Easy Difficult Small

II (SMEs) Example: consumer, credit card, housing and some SME loans.

Approach:

Workout by individual banks, with possibly some across the board procedures or task force to deal with the liquidity problems of SMEs. Example: some SME loans

Viable enterprises: Approach: Workout by individual banks and other financial institutions; some debt-equity swaps, sales to other investors.

Unviable enterprise

ises: liquidation. Large Example: Some type of real estate and other loans

Approach

ch: Transfer to (government- or privately owned) AMC followed by sale. Example:

large corporates Approach: Viable enterprises: Carve-out partly from banks; some debt rescheduling by banks; debt-equity conversion by government agency

Unvi

able enterprises: liquidation

This typology is not to say that all of these agents will necessarily pursue active restructuring of corporates. Some might just be more passive agents. During the systemic restructuring in the transition economies, for example, banks in the end did not actively restructure enterprises; it was a hard budget constraint, and the pursuit of privatization, which encouraged the necessary restructuring. In any case, the typically length of operational and financial corporate restructuring process is quite long.

Recapit

alize before or after corporate restructuring? Government support to banks (and other financial institutions) can be ex-ante or ex-post, which relates to the sequencing of the restructuring of the financial sector with that of the corporate sector. With ex-ante recapitalization, the government recapitalizes banks based on an assessment of their probable losses (determined by outside audits and portfolios reviews). The bank shareholders may be asked to share some of the burden of the losses on the loans, with the extreme where shareholders are completely diluted and the bank is effectively nationalized.

This ex-ante recap

italization approach has benefits. It can be relatively fast and signal to the market that problems are being resolved. Since several East Asian governments have already guaranteed the liabilities of banks (and other financial institutions), recapitalization would formalize this and thus create clarity, including possibly preventing more risk taking by undercapitalized, zombie banks. And, provided it is accompanied by substantive changes in the framework for corporate governance and operations of banks, it can be an up-front investment that may lead to lower ultimate costs.

But has also risks. Yet, ex-ante recapitaliz

ation of banks has risks. As noted, governments routinely respond to (systemic) bank solvency problems by injecting capital into insolvent institutions without achieving sufficient change in banks' governance and operations (see, among others, World Bank, 1995). The mechanisms under which support is provided to financial institutions are often not sufficiently conditioned on progress in operational restructuring of the banks themselves. As a result, recapitalization is often wasted. While clear criteria can be used in the provision of public resources, given the historically large role of East Asian governments in the real and financial sectors and the large corporate sector problems, there is no guarantee that recapitalization will be either sufficient or one-time only. And, if private shareholders of the banks are completely diluted, then the government essentially nationalizes a large share of its banking system, and is thus responsible to act as an owner in controlling management. This has risks of its own, particularly as it will be difficult to re-privatize banks quickly given the lack of good domestic and foreign capital.

Importantly, ex-ante recapitaliz

ation means that is little linking between the restructuring of banks and resolving the corporate sector debt problems, a common root of the financial sector distress in East Asia. With little linkage between the provision of public resources and adequate progress by individual banks in the restructuring of corporates, no market-based, sustainable resolution of the related corporate sector and financial sector problems may result. While recapitalized banks would have the ability to provide financial relief, they may have fewer incentives to work

out loans when recapitalized, as they are able to attract new funds anyhow and have the ability to rollover non-performing loans. And corporates may have little incentive to undertake the necessary operational restructuring, if they can get access to new funds anyhow. Country examples confirm this. In case of Mexico, 1995, there was very little linkages between corporate restructuring and bank recapitalization. Bad loans were transferred to an AMC (FOBABRO), but this institution undertook little restructuring and was even reluctant to sell its loans to outside investors. As a result, the size of the non-performing assets under public management ballooned from .. billion in 1995 to \$64 billion in 1998, or 15 percentage points of GDP.

Tighter linkage between financial sector restructuring and corporate restructuring, with the extreme ex-post recapitalization (i.e., banks would receive public funds as and when they provide financial relief to corporates), could provide more time and maintain more pressures on banks and corporates to come to agreement on realistic financial and operational restructuring. The drawback is that it leaves much uncertainty, and can add to the credit crunch. One intermediate model might be to providing public funds for recapitalizing remaining financial institutions conditioned on sufficient progress in corporate debt restructuring. Thailand, for example, adopted a scheme on August 14 where the government provides Tier 2 capital, which includes conditions on financial institutions undertaking corporate restructuring.

6.

Approached to be pursued in East Asia

The above discussion makes clear that there are many options available and dimensions that can be combined for bank and corporate restructuring in various ways. The preferred choices will depend on country circumstances, including the country's overall macro-economic environment, the fiscal and external financing situation, and other initial conditions. An important initial condition will be the quality of the institutional framework in the country for dealing with financial distress, including the legal and regulatory framework, the quality of information, the level of human capital, and the degree of political influences in the financial and corporate sectors.

While there are no cookie-cut answers, at the same time, it is clear that integrated and comprehensive and integrated solutions are necessary, which implies that the various elements need to be brought together somehow in a consistent manner. Also, the discussion of the weaknesses in East Asian countries makes clear that some options are less preferable. This section therefore discusses some approaches that combine the elements discussed above, and discusses their pros and cons in the context of East Asia. As discussed here, all are, however, stylized models, and country differences will determine their applicability.

The private, ex-ante, bank-led approach. One specific model which combines some choices along these various dimensions is a decentralized, ex-ante recapitalization approach where banks are recapitalized and then take the lead in corporate restructuring, including financial restructuring. This approach has been used in other countries, and is actively being considered in East Asian countries as the main approach. Under this approach, the government recapitalizes banks, based on an ex-ante assessment of their losses, and individual banks, on a decentralized basis, then work out the problem loans. Banks may establish workout



units or create private bad banks, which can remain under their own management and ownership or be spun off to other investors. The tools to provide support to banks can be many, and can involve different degrees of burden. The bank shareholders may be asked to share some of the burden of the losses on the loans, or be completely wiped and the bank being effectively nationalized. The assumption, however, is that existing shareholders of bank are not completely diluted and thus that private agents govern the bank and are in charge of the restructuring of corporates.

At the level of individual corporates, the main function of the creditor banks, together with other creditors, will be to drive the operational restructuring process, reduce the level of debt to appropriate levels, and, if necessary provide new money for working capital purposes. The government would not intervene directly in this corporate sector restructuring process.

This was the approach taken in most transition economies, with some success in Poland, and many developing countries, with mostly limited success.

A decentralized approach has benefits and risks. As noted, general experience shows that this approach to financial and corporate restructuring has benefits and risks. The main disadvantages of the ex-ante recapitalization strategy in an East Asian context are that making banks the agent of change puts a too heavy burden on them and is poorly sequenced with the restructuring of corporates. Most banks in East Asia currently do not have the technical capacity and institutional development needed to deal with the restructuring of a large number of corporates. While the banks capacity has been enhanced, through technical assistance and other institutional building measures, to make banks effective in enterprise restructuring will take substantial time. It is also likely that banks would not be strong enough vis-à-vis corporates in restructuring negotiations. It has been argued, partly because of too big to fail reasons, as well as because of the social and political consequences associated with the necessary enterprise restructuring, that banks will not be able to hold their own vis-à-vis the large corporates, such as the chaebols in Korea or the large family-controlled conglomerates in other countries. This may result in weak corporate restructuring plans and ultimately larger fiscal cost. This risk is further increased by the long-standing links between banks and corporates, through ownership and otherwise, which will prevent arm-length negotiations.

The currently very high debt-equity ratios also imply that corporate restructuring will require substantial debt-equity swaps. But if banks end up with large amounts of equity holdings that they are unlikely to be able to dispose of quickly, banks can become very unstable. Banks thus need to have not only the capacity to absorb losses when they enter negotiations with corporates on financial restructuring, but there also needs to be mechanisms to off-load the equity banks will acquire as a result of the necessary debt-equity swaps. On balance then, this approach has many risks, especially with respect to the restructuring of larger corporates.

A more centralized, public approach. An alternative approach is where the government is more actively involved in the restructuring of individual corporates. Under such an approach, the government, or a government agency, takes over a large share of distressed assets from banks and replaces these assets by government bonds or other safe assets. In that way the government recapitalizes the banks

ng system (which can involve different degrees of burden sharing with existing shareholders). The government then in turn tries to restructure the claims and to force the operational restructuring of corporates. Several East Asian countries have already adopted elements of this approach. In Korea, some fraction of banks non-performing loans has been transferred to the government-owned Korean Asset Management Company (KAMCO), which aims to restructure these loans. A bridge bank in Korea has further assumed distressed assets of merchant banks. In Thailand, the government-owned Asset Management Company (AMC), in competition with the private sector, has acquired assets from defunct finance companies and has been selling some of these, including through auctions. In Malaysia, an AMC has also been set up. In Indonesia, IBRA has acquired the assets of many defunct banks. But as noted, AMCs have had a mixed record, particularly in developing countries.

Either model has drawbacks, particularly in the medium term. Current approaches in East Asia, apart from falling far short of addressing the problem, straddle these two (and other) approaches. Banks are (partly) recapitalized and left to work out the distressed assets, particularly the medium-size and small loans, while some larger loans are transferred to AMCs (and other agencies), with the AMCs to take the lead the restructuring. This approach may work in countries where the problems are predominantly with smaller enterprises, which banks can be expected to restructure, or where there are only a few numbers of large enterprises, which are difficult to restructure and require government involvement. For most East Asian countries, neither situation is likely the case, however. Table .. shows the distribution of firms, which can not service their liabilities from operating income for East Asian countries. Both large and small firms are not able to service their liabilities in full.

Tab

le/chart: distribution of distressed loan by size:

Source: Ferri et al. 1998

It is also not clear these approaches alone will achieve the necessary fundamental changes in the control of corporates. In particular, the shortage of equity will mean that in the financial restructuring of corporates, existing shareholders can not be completely eliminated, as otherwise banks or the government will own much of the corporate sector. At the same time, leaving current shareholders in control, risks perpetuating risky structures and inefficient investments.

Other ways? Additional and other ways to engineer the necessary financial and operational restructuring so as to achieve a better short-term and medium-term outcome may thus be necessary. Such approaches should build on the relative strengths of banks and corporates. As noted (see also Claessens et al. 1998), despite pockets of inefficiency, firms in East Asia are well run, have faced world competition and have performed well against the best international firms. Corporates in East Asian countries are in general institutionally stronger than banks and have to date shown to have relatively better incentives than banks in managing their business. The framework should thus design mechanisms, of sticks and carrots, where in some sense corporates become the lead agent of change. And assets, which involve relatively little complex management, could be transferred to an AMC or sold quickly to help the necessary recapitalization of banks.

Workouts involving multiple parties will be useful in some countries. One possible approach for the larger, more difficult restructuring cases would therefore be workouts involving banks, corporates and the government. Corporates might be forced to apply to this restructuring process by limiting any new lending to a corporate with debt-servicing problems (achieved, inter alia, by greatly increasing the provisioning requirements for loans to such corporates). In the process, a corporate will have its obligations restructured provided it undertakes the necessary operational restructuring. The process should lead to an operational restructuring plan, which can be presented to a committee. This committee could be the equivalent to a creditors committee in a normal reorganization procedures, except that, in addition to the creditor banks and other creditors, an AMC, or other agency or fund would represent the interest of the government. The committee could usefully also include other, independent members and there would be various consultants and staff to support such a committee. The plan approved by this committee should indicate the savings achieved through operational restructuring, sell-off of assets, the contribution in new equity by the existing shareholders, and the degree of financial relief sought and through what modes. If a plan is not accepted, the corporate might be due for a standard bankruptcy process. And, to prevent willful default, sanctions on non-payment by viable borrowers (such as liquidation of assets) need to be in place.

The form of financial relief provided by creditor banks could mainly be a lengthening of maturities and some interest relief, but only very limited debt-equity swaps. Banks may provide working capital, but only under strict conditions (e.g., only highly collateralized). The AMC, or other types of government-owned funds, would be allowed to take over some loans from creditor banks and swap some of these claims into equity. By substituting equity for debt, the enterprise would be provided with financial relief to overcome its financial problems.

Most importantly, there need to be incentives and controls to ensure that the corporate restructuring leads to financially viable firms and that the terms at which debt is converted and equity is valued is done consistent with market principles. This will require that there is sufficient participation by the private sector in the corporate restructuring, both through putting up private capital and through heavy involvement of private management as part of the restructuring process. One way would be to make these funds jointly private and publicly owned, with the private shareholders becoming the ultimate residual claimholder. This would assure that the most junior claimholder, the private shareholder in the fund, who has to make the ultimate decision on the viability of the financial restructuring, faces the right incentives. And the public resources necessary will only be provided at the point when all parties, creditor banks, other non-financial institutions creditors, and the private shareholders of the fund, have reached agreement with the individual corporate.

This approach could lead to deeper equity market. As an equity holder, perhaps the largest single holder, the AMC or funds would have the responsibility to assure that the enterprises are properly managed. One does not wish, however, the government to become a permanent owner of corporates. Disposal of the securities acquired through sales to strategic or portfolio investors over as short as possible period of time would be desirable, but this will be difficult given the limited supply of (domestic and foreign) capital. Several options might be open.

One could consider transferring these equity claims to taxpayers as a form of compensation for the (additional) taxes. Or the shares could be transferred to an institution (or institutions) to be managed for the public's benefit. For example, the shares could become the basis of a privately managed, funded pension scheme. Other schemes are also possible: workers laid off could be provided with shares in dedicated equity funds that hold equities in the firm or firms in the same sector. Or citizens could be encouraged to purchase shares through advantageous financing schemes (e.g., limited down payments and extended maturities). Many of these elements were used in Chile in the 1980s (see earlier box), when it nationalized and then privatized its firms through various means. Also elements of the structures of the national privatization funds in Poland, which were used for the privatization of large state enterprises, can possibly be applied in the East Asian context.

There are several potential advantages to this type of an approach to the combined problems of corporate and bank restructuring. First, it would deal with the stock problem within the framework and context of financial sector restructuring, where the governments have already committed their resources directly. Second, it would not break the link between banks and corporates, as banks remain significant lenders of viable firms. This may have a positive value, given banks' privileged access to information. Third, it includes all parties involved simultaneously (banks, government, AMC, other agencies and corporates), and incentives are balanced, with a heavy emphasis on corporates to come up with credible operational restructuring plans. Also, by undertaking simultaneously debt reduction and debt-to-equity swaps by the AMC or other funds, and debt restructuring and new money by the banks, the power of creditors over the corporates is enhanced. Finally, if the conversion of loans to equity has enough private sector involvement and is linked to the creation of pension funds, mutual funds etc., the governance of corporates in the medium-term might be improved as a set of large, active outside owners is created.

Still, many questions need to be addressed. Regardless of approaches taken, many other issues need to be resolved in the combined problem of bank and corporate restructuring. What will the loss sharing be between banks and the government? How far will loans be written down to market value and then replaced by government bonds; or will the bank be given full relief/support? What will be required from the existing shareholders of corporates and banks? How far will equity holders be diluted? What is a proper supportive macro-economic policy? Possibly, there are other ways?

## 7. The remaining and unresolved issues and main messages (incomplete)

Unresolved issues:

Macro-policy stance is crucial, but what are tradeoffs (exchange rate/interest rate)

Reducing overall uncertainty requires

comprehensive approach, but this needs to be backed up by sufficient public support

Bailing in private creditors and existing shareholders necessary, but how to achieve

The need for whole-sale debt relief in some countries (e.g., Indonesia), but unclear how to structure



## Main messages:

It is a process

Requir

ing sufficient public resources, which may not always be available

Links betwee

n financial sector restructuring and corporate restructuring need to be taken i

nto account through properly structured loss-absorption mechanisms

Changes in i

nstitutions, rules of the games, and attitudes are necessary

Liquidity is neces

sary, which in turn requires bailing in of private creditors and existing share

holders, and possibly a major rescheduling/debt relief on external debt.

Regula

tory changes need to balance need for fundamental reforms with counter-cyclical policies.

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Albeit that the excessive exposures appear to be more concentrated in the banking systems in the case of East Asia, see McKinnon and Pill, 1998.

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and delinquencies by state governments, and their (unpaid) suppliers, have been at the root of the large insolvencies of state-owned banks in Brazil (1994-95) and Nigeria (1993).

In particular, liabilities of non-bank financial institutions are not all guaranteed and in any case, for moral hazard reasons, public resources should be limited to retail deposits that are formally guaranteed and to deposit-taking institutions which are of systemically importance.

Sharpe 199

5 reviews the literature on the credit crunch in the US during the 1990-91 recession when bank lending was weak during this period and several years thereafter. He concludes that deterioration in banks balance sheets and profitability had been found to have a robust negative relationship with loan growth, but changes in capital standards or regulatory behavior do not have a convincing tie to the drop in aggregate lending.

This flight to quality is to be expected and can actually be an important disciplining device. In an analysis of the 1995 Argentine banking crisis, Schumacher, 1997 finds, controlling for the systemic run on the banking system, that, in the absence of deposit insurance and a limited nature of lender of last resort, depositors imposed discipline on banks through flight to quality (i.e., depositors reallocated deposits from weaker banks that were offering higher interest rates to foreign banks and the ten largest domestic retail banks). Soledad and Schmukler (1998) find similar results for the behavior of insured and uninsured depositors as well as large and small depositors in Argentina, Chile and Mexico during the 1980s and 1990s.

Use of infla

tion to raise spreads, as well as finance government deficits, has also been used in a number of countries, including Turkey (early 1980s) and Argentina (1980s, where a number of episodes of hyper-inflation developed). Turkish private banks (but not public banks) were able to recapitalize, but Argentine banks were not, and Argentina had to resort to some write-down of depositor claims in the early 1990s.

Expand with Anything from Core Principles, or other sources?

In

some countries, such as the Philippines, the problem of personal liability of government officials is further compounded by uncertainty whether these officials can be represented in lawsuits by government attorneys (example from Waxman, 1998).

As noted, in several countries NBFIs engaged in risky lending in part because their funding costs were relatively high as they were not allowed to engage in retail deposit-taking. Combined with low franchise value this can create large risks.

It should be noted that the PCA-scheme in the US still allows r

regulators some discretion in cases. Where resolution would have serious adverse effects on economic conditions or financial stability the FDIC can allow for full protection of depositors and other creditors. This thus opens the possibility of too big to fail support. See further, Feldman and Rolnick, 1997. Some (Rosengren and Peek, 1997) have also argued that PCA would have little, if any effect during the banking crisis in New England in the US in the early 1990s, since it imposes an essentially non-binding constraint.

Degennaro and Thomson (forthcoming) compare the estimated cost of resolving the insolvencies of the 996 FSLIC-insured savings and loan institutions that did not meet capital standards on December 31, 1979 with the actual failure-resolution costs. Their most conservative estimate, considering only the direct costs associated with delayed closure of only the 372 thrifts that were subsequently closed as independent institutions, show that these costs exceed estimates of the cost of prompt resolution by over 16 billion in 1979-dollars.

To illustrate, the net present value of any post-restructuring debt service to a secured creditor should at least equal the NPV of anticipated proceeds if the secured creditor were to immediately commence litigation or litigation proceedings to enforce the security.

A three-level hierarchy in implementing this principle is foreseen. First, the debtor would absorb losses through disposals of non-core assets, elimination or postponement of non-essential capital expenditures. Second, shareholders would eliminate dividends, inter-company payments, etc. and would write-down capital as appropriate. Third, creditor losses would be shared among same-class creditors on a pro rata basis, subject to the principle regarding collateral rights of secured creditors.

Mergers were initially used to try to resolve the S&L crisis.

The program had limited success since it was difficult to attract quality management and new, outside investors willing to risk capital. Only when the government began to offer financial incentives, were regulators able to attract purchasers for the better franchise values (see further Sheng, 1996 and Waxman, 1998).

It is difficult, but not impossible, to handle real property in a centralized unit.

Also, banks that have preserved their solvency during the calamity but have insufficient capital to meet the minimum capital standards, can with justification, complain that it is unfair not to offer them assistance while aiding banks that are in worse condition. Competition from assisted banks may impede the recovery of those that remain unassisted. This makes it all the more important that eligibility should be determined by financial criteria and potential viability, not size, types, or influence.

Expand with OBA, puts, loss sharing, interest guarantees, equity infusions on a sharing basis (RFC-type), with/without put-back options, options to buy, etc.. ?

Where the markets are deep and the government can sell bonds to raise cash readily without increasing interest rates markedly, cash injections have advantages. For example, they avoid the problems associated with the governments provision of bonds paying below market interest rates and they increase the liquidity that is needed to service the economy. However, the governments ability to sell bonds or issue negotiable bonds to banks is constrained in many countries because of their potential effects on a thin or strained bond market. Furthermore, when there are concerns about the adequacy of management, governance, or the operational restructuring plan,



and when concerns over deposit runs have passed, the government may prefer to inject nonnegotiable bonds, which provide income to the banks but cannot be sold and converted into risky and lossproducing assets. Such bonds could become negotiable after a period of time, but only when progress has been made on operational restructuring.

All banks would have to provide rehabilitation plan to show how, with support, they would be able to meet the capital adequacy targets. Banks not willing to enter these loss-sharing agreements cum provision of new private capital would also need to provide rehabilitation plans showing how they would be able to meet capital adequacy requirements without support. Banks failing to come up with adequate rehabilitation plans by a certain date would be closed. All banks would of course be subject to intense supervision and rehabilitation plans would be reviewed by third parties.

Officially, KAMCO had a claim on the bank to the extent that it was not able to recover up to the net amount, but this may not have been enforceable if banks themselves became insolvent. More recently, the government has decided to take over loans at expected recovery or nominal values, thus shifting the loss back to the bank.

In the end, there was substantial relief provided to the old shareholders of the banks (see

In Capital Markets And Legal Institutions, Rafael La Porta and Florencio Lopez-de-Silanes evaluate the effect of laws governing investor and creditor protection, and the quality of enforcement of these laws on the availability of external financing in 49 countries. Their evidence advanced by La Porta and Lopez-de-Silanes suggests that the legal protection matters for depth of development of capital markets.

Ideally the Board of Directors can become an agent of change for policies, legal processes, CEO succession, and strategic planning. For instance, the board can promote governance by actively exert the right to obtain meaningful information, and promoting transparency via enhanced (financial) disclosure; taking an active role in the evaluation of the CEO, including compensation and succession; and monitoring itself to ensure adequate Board composition and director selection. Also, evaluation of the board and its members; and Directors compensation and stock ownership.

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ARMS Email SystemRECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Allison Fansler ( CN=Allison Fansler/O=Department of the Treasury [ UNKNOWN ] )

CREATION DATE/TIME: 3-SEP-1998 19:49:38.00

SUBJECT: weekly

TO: David S. Beaubaire ( CN=David S. Beaubaire/OU=WHO/O=EOP @ EOP [ WHO ] )

READ:UNKNOWN

TO: Cabinet Affairs ( Cabinet Affairs [ UNKNOWN ] )

READ:UNKNOWN

TO: Lisa J. Levin ( CN=Lisa J. Levin/OU=WHO/O=EOP @ EOP [ WHO ] )

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TO: Jon P. Jennings ( CN=Jon P. Jennings/OU=WHO/O=EOP @ EOP [ WHO ] )

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TEXT:

September 2, 1998

MEMORANDUM FOR ERSKINE BOWLES, THE WHITE HOUSE

FROM: Robert E. Rubin

SUBJECT: Weekly Report for the week of September 7, 1998

HOT ISSUES

Russia

Japan

Customs

KEY NEWS

Russia: On August 31- September 2, President Clinton, Deputy Secretary Summers, and other Administration officials traveled to Russia for the Moscow Summit with President Yeltsin. Deputy Secretary Summers met separately with several Russian officials, including Central Bank Governor Dubinin, Anatoly Chubais, and Boris Berezovsky. Russian markets continue their sharp decline following the Dumas rejection of the appointment of Chernomyrdin as prime minister on August 31.

Japan: On September 4, Secretary Rubin, Federal Reserve Chairman Greenspan, Deputy Secretary Summers, and Federal Reserve Governor Meyer will travel to San Francisco to meet with Japanese Finance Minister Miyazawa. The officials will discuss the Japanese economy and financial sector issues, as well as developments in global markets, notably those in Asia, Russia and Latin America.

Latin America: On September 3-4, the Secretary Rubin will attend a meeting



hosted by the IMF of Finance Ministers and Central Bank Governors from nine Latin American countries most exposed to international financial markets, including Mexico, Argentina, Brazil, and Venezuela. Federal Reserve Vice-Chairman Rivlin, Canadian officials, and officials from the World Bank and Inter-American Development Bank will also participate. The purpose of the meeting is to review global economic and financial developments and discuss Latin American economic policies in that context. Secretary Rubin will also host a working dinner for all the participants on September 3.

**Customs:** On September 2, Customs Commissioner Kelly announced that the U.S. Customs Service had executed 32 Federal search and seizure warrants in 22 states around the United States to search for evidence in an investigation of a worldwide child pornography trading ring that involves more than 100 suspects in 14 countries around the world. The investigation was part of a global investigation that stems from information the U.S. Customs Service developed during a 1996 investigation of a child pornography trading and molestation ring.

**East Asia:** While Indonesia, Korea and Thailand all continue to make progress in implementing their reform programs backed by the international community, Malaysia and Hong Kong have recently taken action targeted at punishing speculative activity. The Hong Kong Monetary Authority intervened heavily in equity cash and futures markets during the last two weeks of August in an effort to combat short-selling of stocks and speculation against the Hong Kong Dollar, while Malaysia imposed new capital controls on September 1. It is not yet clear whether these measures will be successful in deterring future speculation, but market participants are generally skeptical about the ability of these policies to boost confidence in the prospects for these economies.

**Stock Market Developments:** As U.S. equity markets fell on August 28 and 31, Treasury officials monitored the situation and kept in close contact with officials at the Fed, the SEC, and other market regulators to evaluate the functioning of the market. Regulators reported that the market functioned in an orderly fashion, and Treasury continues to work with the staff of these regulators to further monitor market developments.

**Inflation-Indexed Savings Bonds:** On September 1, Treasury began selling inflation-indexed savings bonds with a guaranteed 3.4 percent initial fixed rate of return over inflation. The bonds are attractive to investors because they protect investors from inflation; they are exempt from state and local income taxes and federal taxes can be deferred until the bond is redeemed or stops earning interest at 30 years; they increase in value monthly with interest compounded semiannually; and all or part of the interest earned may be tax-exempt if used for college tuition and fees at eligible post-secondary educational institutions, when income qualifications are met. Each of the eight bonds also features the portrait of a historically significant American.

**Electronic Filing:** On August 20, the IRS announced several new arrangements with private sector firms which ease barriers for taxpayers who file returns and pay taxes electronically. Beginning in 1999, all taxpayers who file electronically will be able to pay their taxes using

most major credit cards by calling a toll-free telephone number. Working with Intuit Corporation, H&R Block, and preparers, the IRS will also pilot the use of personal identification numbers (PINs) in lieu of paper signatures on electronically filed returns. These tests are designed to find ways to eliminate the need for taxpayers and practitioners to mail paper documentation to IRS.

## WORK ON PRESIDENTIAL INITIATIVES

Electronic Funds Transfer (EFT)'99: On August 20, Under Secretary Hawke, Fiscal Assistant Secretary Hammond, FMS Commissioner Gregg and other Treasury staff held an EFT99 forum for over 130 Federal agency representatives designed to brief the agencies on the key aspects of implementing EFT99. It was repeatedly emphasized to the agencies that under no circumstances would payments to Federal recipients be withheld or delayed due to EFT99. On August 14, Under Secretary Hawke and staff also met with H&R Block to discuss the implications and opportunities of EFT and the electronic transfer account (ETA) for the commercial tax preparation industry. Block has an arrangement with Mellon Bank whereby clients who do not have a bank account can have a special Direct Deposit account established, and when the refund is electronically deposited, the Block tax preparation fee is automatically deducted. Treasury is exploring whether this type of arrangement could potentially be broadened to provide expanded services for the unbanked.

Business LINC: Treasury continues working on the Business LINC initiative announced by the Vice President in July, designed to encourage the linkage of large businesses to locally-owned small businesses in distressed areas to increase their economic competitiveness. These programs, including one-on-one technical assistance, boards of advisors, classroom business training, and supplier development programs, benefit small firms by providing technical assistance, improved market and financial access, expansion opportunities, and procurement opportunities. Treasury has held regional meetings in Los Angeles, Chicago, Dallas, and Cleveland, and will hold meetings in New York on September 11 and Atlanta on September 18. Treasury is also putting together a website that will help match large and small businesses interested in mentoring, and will continue to work with local communities to keep attention focused on mentoring after the regional meetings are over. Treasury has also established a CEO Group that will review the report, including the CEOs of Chase Manhattan, General Motors, GE Capital, SAIC, Trumark, and ITC Personnel Services.

## CONGRESSIONAL ACTIVITY

IMF: On September 2, the Senate voted 90-3 to approve the FY99 Foreign Operations bill with the full \$18 billion in funding for the IMF. On September 1, Secretary Rubin sent letters to Sens. Lott and Daschle and Reps. Gingrich and Gephardt urging immediate action on the IMF funding, and copies of the letter were sent to the entire Senate and House. During the past few weeks, Treasury officials have met with staff to the House Minority Leadership as well as several committees, including House and Senate Banking and Senate International Relations to brief them on the

Russian financial crisis and the IMF. The discussions centered around the new Russian policies concerning currency and restructuring and the economic/political climate that led to these reforms and the role of the IMF. Treasury will continue working to limit opportunities for IMF opponents to add unacceptable conditions on the IMF funding. The House is expected to mark up its FY99 Foreign Operations bill in full committee on the September 10 or 17.

Customs Reauthorization: On September 3, Under Secretary Johnson and Customs Commissioner Kelly testified before the Senate Finance Committee. Under Secretary Johnson discussed the role of the U.S. Customs Service in the protection of our borders and the facilitation of trade, and Commissioner Kelly focused on a more detailed discussion of the current state of affairs at Customs.

NADBank: During the August recess, Treasury staff and NADBank Director Loftus met with key border state Members and staff, including Reps. Filner, Bonilla, and Rodriguez and staff to Sens. Domenici and Hutchison. Prior to the August recess, Treasury and NADBank staff met with staff to Sens. Domenici and Hutchison, both of whom sit on the Appropriations Committee, to seek support for the President's \$37 million request for the CAIP. As of August 31, the Community Adjustment and Investment Program (CAIP) has assisted with the financing of 132 loan guarantees in twenty states with a principal amount of over \$82.5 million.. Treasury will continue to work with key border state Members in an effort to secure CAIP funding in the conference to the Foreign Operations Appropriations bill.

Digital Counterfeiting: On October 5-6, Treasury, in conjunction with the Federal Reserve, is hosting a two day anti-digital counterfeiting of US currency forum. Under Secretaries Hawke and Johnson and Federal Reserve Governor Kelley have invited policy and technical representatives from companies involved in digital technologies to participate. The goal of the forum is to begin a process by which a technological solution to digital counterfeiting of currency can be developed.

## PRESS ACTIVITY

International: On August 17, Deputy Secretary Summers held a background conference call on Russia with reporters from The Washington Post, New York Times, USA Today, Wall Street Journal, Financial Times, Los Angeles Times, Time, Newsweek and the financial wires. On August 17, Under Secretary David Lipton spoke with editorial writers from The New York Times and The Washington Post about the Russian governments recent actions. On August 18, Under Secretary Lipton spoke with the Financial Times about his visit to Russia, and on August 19, spoke with Newsweek about the current Russian economic situation and how US economic policies towards Russia have evolved. On August 20, Lipton spoke with The New York Times and The Washington Post about his trip to Russia and the current financial situation.

On August 20, Deputy Assistant Secretary Medish spoke with The Buffalo News for an editorial on Russia. On August 21, Under Secretary Lipton spoke

with the New York Times on Russia. On August 24, Assistant Secretary Geithner spoke with Reuters about the IMF and Treasurys response to the developments in world markets. On August 26, Assistant Secretary Geithner held a conference call on the Russian economic situation with reporters from The Washington Post, The New York Times, USA Today, Wall Street Journal, Financial Times, Los Angeles Times, Time, Newsweek and the financial wires. On August 27, Deputy Secretary Summers held a conference call on Russia and the global economic situation with reporters from The Washington Post, The New York Times, USA Today, Wall Street Journal, Financial Times, Los Angeles Times, Time, Newsweek and the financial wires. On August 28, Deputy Secretary Summers joined National Security Advisor Berger for a White House Press Briefing on the Russian economic situation, the Presidents upcoming trip to Russia and his meeting with President Yeltsin. On August 30, Deputy Secretary Summers appeared on CBS Face the Nation, to discuss the economic, financial and political environments of Russia and its future.

On August 31, Secretary Rubin spoke with NBC Anchor Tom Brokaw regarding the markets, Russias economic and financial situation and the Presidents trip and meeting with President Yeltsin. On August 31, Secretary Rubin read a statement to the Treasury Press Room wire reporters regarding the activities of the financial markets reassuring that the payment and settlement system and other market mechanisms are working effectively and that the United States economy is strong. In addition to the wires, stories were carried by Wall Street Journal, the New York TimesYT, WP, USA Today, Washington Times, Financial Times.

Domestic Finance: On August 17, Acting Fiscal Assistant Secretary Hammond spoke with the Sacramento Bee concerning EFT99 and on August 20 spoke with Buffalo News for a column encouraging seniors to enroll in the EFT program. On August 25, Assistant Secretary Gensler spoke with New Choices detailing Treasury Direct, and on August 26, Acting Fiscal Secretary Hammond spoke with the Cincinnati Post on EFT99.

U.S. Treasurer: On August 25, U.S. Treasurer Withrow traveled to the Federal Reserve Bank in Minneapolis, Minnesota, and spoke to Minnesota Public Radio, WCCO Radio and appeared on News Might Minnesota on KTCA-TV to discuss the new \$20 bill. On September 1, Treasurer Withrow appeared on WHYY-TV regarding new currency and on September 2, addressed the Delaware Bankers Association on the same subject.

Enforcement: On August 14, Customs Commissioner Kelly taped an interview with ExtraTV on Customs strip searches and the ongoing Treasury review. The interview will air as part of a segment on August 24. On August 19, OFAC Director Newcomb spoke on background to The Dallas Morning News on the Cuba Assets Control Regulations for an upcoming conference that the Morning News will hold on Cuba. On August 22, OFAC Director Newcomb participated in a background briefing to the White House press pool following the Presidents radio address on the addition of Osama bin Laden to Treasurys Specially Designated Terrorists program. Background interviews were also provided to Newsweek and The Washington Post. On August 26, ATF Public Affairs Chief Roehm gave a briefing at the National Press Club on the ATF mission and their role in protecting Americas public safety, which was carried live on C-SPAN.



Tax Policy: On August 18, Deputy Assistant Secretary Scholz spoke with the Wall Street Journal regarding the projected surplus on the stock market. On August 19, Assistant Secretary Killefer spoke with Tax Notes regarding the IRS Oversight Board and its membership. The story ran in the August 24 issue.

## SECRETARYS SCHEDULE

### The Week in Review

Monday, August 31

Met with Treasury Press Corps to discuss developments in the financial markets.

Tuesday, September 1

Met with OMB Director Lew and Deputy Director Mathews to discuss FY99 Appropriations.

Wednesday, September 2

No external meetings.

Thursday, September 3

Will meet with Finance Ministers from Latin America.

Interview with Jeff Birnbaum, Fortune Magazine.

Will meet with Western Hemisphere Finance Ministers.

Will host dinner for Western Hemisphere Finance Ministers.

Friday, September 4

Traveled to San Francisco.

Met with Japanese Finance Minister Miyazawa to discuss the Asian financial crisis and the Japanese economy.

Held press conference to discuss the meeting with Minister Miyazawa.

Hosted a dinner with Minister Miyazawa and Chairman Greenspan and others.

### The Week Ahead

Monday, September 7

Labor Day - Federal Holiday

Tuesday, September 8

Will meet with George Becker, United Steelworkers of America, to discuss steel trade issues.

Will participate in the Working Group on Financial Markets Principals meeting.

Wednesday, September 9

Breakfast with Chairman Greenspan.

Will meet with Neal Lane, White House Office of Science and Technology.

Will meet w/Steel Industry Representatives to discuss trade issues.

Thursday, September 10

Will meet with a delegation from the American Farm Bureau Federation to discuss IMF funding and Fast Track.

Will attend President Clintons Cabinet meeting.

Friday, September 11  
No external schedule.

ARMS Email SystemRECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa J. Levin ( CN=Lisa J. Levin/OU=WHO/O=EOP [ WHO ] )

CREATION DATE/TIME: 4-SEP-1998 08:30:52.00

SUBJECT: weekly

TO: Helen Veit ( CN=Helen Veit/OU=WHO/O=GOV @ WHO [ UNKNOWN ] )  
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TEXT:

----- Forwarded by Lisa J. Levin/WHO/EOP on 09/04/98  
08:30 AM -----

Allison Fansler @ DEPARTMENT OF THE TREASURY  
09/03/98 07:47:41 PM  
Record Type: Record

To: Cabinet Affairs, Jon P. Jennings/WHO/EOP, David S. Beaubaire/WHO/EOP,  
Lisa J. Levin/WHO/EOP  
cc:  
Subject: weekly

September 2, 1998

MEMORANDUM FOR ERSKINE BOWLES, THE WHITE HOUSE

FROM: Robert E. Rubin

SUBJECT: Weekly Report for the week of September 7, 1998

HOT ISSUES

Russia  
Japan  
Customs

KEY NEWS

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**Stock Market Developments:** As U.S. equity markets fell on August 28 and 31, Treasury officials monitored the situation and kept in close contact with officials at the Fed, the SEC, and other market regulators to evaluate the functioning of the market. Regulators reported that the market functioned in an orderly fashion, and Treasury continues to work with the staff of these regulators to further monitor market developments.

**Inflation-Indexed Savings Bonds:** On September 1, Treasury began selling inflation-indexed savings bonds with a guaranteed 3.4 percent initial fixed rate of return over inflation. The bonds are attractive to investors because they protect investors from inflation; they are exempt from state and local income taxes and federal taxes can be deferred until the bond is redeemed or stops earning interest at 30 years; they increase in value monthly with interest compounded semiannually; and all or part of the interest earned may be tax-exempt if used for college tuition and fees at eligible post-secondary educational institutions, when income qualifications are met. Each of the eight bonds also features the



portrait of a historically significant American.

**Electronic Filing:** On August 20, the IRS announced several new arrangements with private sector firms which ease barriers for taxpayers who file returns and pay taxes electronically. Beginning in 1999, all taxpayers who file electronically will be able to pay their taxes using most major credit cards by calling a toll-free telephone number. Working with Intuit Corporation, H&R Block, and preparers, the IRS will also pilot the use of personal identification numbers (PINs) in lieu of paper signatures on electronically filed returns. These tests are designed to find ways to eliminate the need for taxpayers and practitioners to mail paper documentation to IRS.

## WORK ON PRESIDENTIAL INITIATIVES

**Electronic Funds Transfer (EFT)'99:** On August 20, Under Secretary Hawke, Fiscal Assistant Secretary Hammond, FMS Commissioner Gregg and other Treasury staff held an EFT99 forum for over 130 Federal agency representatives designed to brief the agencies on the key aspects of implementing EFT99. It was repeatedly emphasized to the agencies that under no circumstances would payments to Federal recipients be withheld or delayed due to EFT99. On August 14, Under Secretary Hawke and staff also met with H&R Block to discuss the implications and opportunities of EFT and the electronic transfer account (ETA) for the commercial tax preparation industry. Block has an arrangement with Mellon Bank whereby clients who do not have a bank account can have a special Direct Deposit account established, and when the refund is electronically deposited, the Block tax preparation fee is automatically deducted. Treasury is exploring whether this type of arrangement could potentially be broadened to provide expanded services for the unbanked.

**Business LINC:** Treasury continues working on the Business LINC initiative announced by the Vice President in July, designed to encourage the linkage of large businesses to locally-owned small businesses in distressed areas to increase their economic competitiveness. These programs, including one-on-one technical assistance, boards of advisors, classroom business training, and supplier development programs, benefit small firms by providing technical assistance, improved market and financial access, expansion opportunities, and procurement opportunities. Treasury has held regional meetings in Los Angeles, Chicago, Dallas, and Cleveland, and will hold meetings in New York on September 11 and Atlanta on September 18. Treasury is also putting together a website that will help match large and small businesses interested in mentoring, and will continue to work with local communities to keep attention focused on mentoring after the regional meetings are over. Treasury has also established a CEO Group that will review the report, including the CEOs of Chase Manhattan, General Motors, GE Capital, SAIC, Trumark, and ITC Personnel Services.

## CONGRESSIONAL ACTIVITY

**IMF:** On September 2, the Senate voted 90-3 to approve the FY99 Foreign Operations bill with the full \$18 billion in funding for the IMF. On

September 1, Secretary Rubin sent letters to Sens. Lott and Daschle and Reps. Gingrich and Gephardt urging immediate action on the IMF funding, and copies of the letter were sent to the entire Senate and House. During the past few weeks, Treasury officials have met with staff to the House Minority Leadership as well as several committees, including House and Senate Banking and Senate International Relations to brief them on the Russian financial crisis and the IMF. The discussions centered around the new Russian policies concerning currency and restructuring and the economic/political climate that led to these reforms and the role of the IMF. Treasury will continue working to limit opportunities for IMF opponents to add unacceptable conditions on the IMF funding. The House is expected to mark up its FY99 Foreign Operations bill in full committee on the September 10 or 17.

Customs Reauthorization: On September 3, Under Secretary Johnson and Customs Commissioner Kelly testified before the Senate Finance Committee. Under Secretary Johnson discussed the role of the U.S. Customs Service in the protection of our borders and the facilitation of trade, and Commissioner Kelly focused on a more detailed discussion of the current state of affairs at Customs.

NADBank: During the August recess, Treasury staff and NADBank Director Loftus met with key border state Members and staff, including Reps. Filner, Bonilla, and Rodriguez and staff to Sens. Domenici and Hutchison. Prior to the August recess, Treasury and NADBank staff met with staff to Sens. Domenici and Hutchison, both of whom sit on the Appropriations Committee, to seek support for the President's \$37 million request for the CAIP. As of August 31, the Community Adjustment and Investment Program (CAIP) has assisted with the financing of 132 loan guarantees in twenty states with a principal amount of over \$82.5 million.. Treasury will continue to work with key border state Members in an effort to secure CAIP funding in the conference to the Foreign Operations Appropriations bill.

Digital Counterfeiting: On October 5-6, Treasury, in conjunction with the Federal Reserve, is hosting a two day anti-digital counterfeiting of US currency forum. Under Secretaries Hawke and Johnson and Federal Reserve Governor Kelley have invited policy and technical representatives from companies involved in digital technologies to participate. The goal of the forum is to begin a process by which a technological solution to digital counterfeiting of currency can be developed.

## PRESS ACTIVITY

International: On August 17, Deputy Secretary Summers held a background conference call on Russia with reporters from The Washington Post, New York Times, USA Today, Wall Street Journal, Financial Times, Los Angeles Times, Time, Newsweek and the financial wires. On August 17, Under Secretary David Lipton spoke with editorial writers from The New York Times and The Washington Post about the Russian governments recent actions. On August 18, Under Secretary Lipton spoke with the Financial Times about his visit to Russia, and on August 19, spoke with Newsweek about the current Russian economic situation and how US economic policies towards Russia

have evolved. On August 20, Lipton spoke with The New York Times and The Washington Post about his trip to Russia and the current financial situation.

On August 20, Deputy Assistant Secretary Medish spoke with The Buffalo News for an editorial on Russia. On August 21, Under Secretary Lipton spoke with the New York Times on Russia. On August 24, Assistant Secretary Geithner spoke with Reuters about the IMF and Treasurys response to the developments in world markets. On August 26, Assistant Secretary Geithner held a conference call on the Russian economic situation with reporters from The Washington Post, The New York Times, USA Today, Wall Street Journal, Financial Times, Los Angeles Times, Time, Newsweek and the financial wires. On August 27, Deputy Secretary Summers held a conference call on Russia and the global economic situation with reporters from The Washington Post, The New York Times, USA Today, Wall Street Journal, Financial Times, Los Angeles Times, Time, Newsweek and the financial wires. On August 28, Deputy Secretary Summers joined National Security Advisor Berger for a White House Press Briefing on the Russian economic situation, the Presidents upcoming trip to Russia and his meeting with President Yeltsin. On August 30, Deputy Secretary Summers appeared on CBS Face the Nation, to discuss the economic, financial and political environments of Russia and its future.

On August 31, Secretary Rubin spoke with NBC Anchor Tom Brokaw regarding the markets, Russias economic and financial situation and the Presidents trip and meeting with President Yeltsin. On August 31, Secretary Rubin read a statement to the Treasury Press Room wire reporters regarding the activities of the financial markets reassuring that the payment and settlement system and other market mechanisms are working effectively and that the United States economy is strong. In addition to the wires, stories were carried by Wall Street Journal, the New York TimesYT, WP, USA Today, Washington Times, Financial Times.

Domestic Finance: On August 17, Acting Fiscal Assistant Secretary Hammond spoke with the Sacramento Bee concerning EFT99 and on August 20 spoke with Buffalo News for a column encouraging seniors to enroll in the EFT program. On August 25, Assistant Secretary Gensler spoke with New Choices detailing Treasury Direct, and on August 26, Acting Fiscal Secretary Hammond spoke with the Cincinnati Post on EFT99.

U.S. Treasurer: On August 25, U.S. Treasurer Withrow traveled to the Federal Reserve Bank in Minneapolis, Minnesota, and spoke to Minnesota Public Radio, WCCO Radio and appeared on News Might Minnesota on KTCA-TV to discuss the new \$20 bill. On September 1, Treasurer Withrow appeared on WHY-TV regarding new currency and on September 2, addressed the Delaware Bankers Association on the same subject.

Enforcement: On August 14, Customs Commissioner Kelly taped an interview with ExtraTV on Customs strip searches and the ongoing Treasury review. The interview will air as part of a segment on August 24. On August 19, OFAC Director Newcomb spoke on background to The Dallas Morning News on the Cuba Assets Control Regulations for an upcoming conference that the Morning News will hold on Cuba. On August 22, OFAC Director Newcomb participated in a background briefing to the White House press pool

following the Presidents radio address on the addition of Osama bin Laden to Treasurys Specially Designated Terrorists program. Background interviews were also provided to Newsweek and The Washington Post. On August 26, ATF Public Affairs Chief Roehm gave a briefing at the National Press Club on the ATF mission and their role in protecting Americas public safety, which was carried live on C-SPAN.

Tax Policy: On August 18, Deputy Assistant Secretary Scholz spoke with the Wall Street Journal regarding the projected surplus on the stock market. On August 19, Assistant Secretary Killefer spoke with Tax Notes regarding the IRS Oversight Board and its membership. The story ran in the August 24 issue.

## SECRETARYS SCHEDULE

### The Week in Review

Monday, August 31

Met with Treasury Press Corps to discuss develops in the financial markets.

Tuesday, September 1

Met with OMB Director Lew and Deputy Director Mathews to discuss FY99 Appropriations.

Wednesday, September 2

No external meetings.

Thursday, September 3

Will meet with Finance Ministers from Latin America.

Interview with Jeff Birnbaum, Fortune Magazine.

Will meet with Western Hemisphere Finance Ministers.

Will host dinner for Western Hemisphere Finance Ministers.

Friday, September 4

Traveled to San Francisco.

Met with Japanese Finance Minister Miyazawa to discuss the Asian financial crisis and the Japanese economy.

Held press conference to discuss the meeting with Minister Miyazawa.

Hosted a dinner with Minister Miyazawa and Chairman Greenspan and others.

### The Week Ahead

Monday, September 7

Labor Day - Federal Holiday

Tuesday, September 8

Will meet with George Becker, United Steelworkers of America, to discuss steel trade issues.

Will participate in the Working Group on Financial Markets Principals meeting.

Wednesday, September 9

Breakfast with Chairman Greenspan.

Will meet with Neal Lane, White House Office of Science and Technology.

Will meet w/Steel Industry Representatives to discuss trade issues.

Thursday, September 10

Will meet with a delegation from the American Farm Bureau Federation to discuss IMF funding and Fast Track.

Will attend President Clintons Cabinet meeting.

Friday, September 11

No external schedule.



ARMS Email SystemRECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa J. Levin ( CN=Lisa J. Levin/OU=WHO/O=EOP [ WHO ] )

CREATION DATE/TIME:11-SEP-1998 13:49:13.00

SUBJECT: weekly

TO: Colin VanOstern ( CN=Colin VanOstern/OU=WHO/O=GOV @ WHO [ UNKNOWN ] )  
READ:UNKNOWN

TEXT:

----- Forwarded by Lisa J. Levin/WHO/EOP on 09/11/98  
01:49 PM -----

Allison Fansler @ DEPARTMENT OF THE TREASURY

09/11/98 12:41:21 PM

Record Type: Record

To: Cabinet Affairs, David S. Beaubaire/WHO/EOP, Lisa J. Levin/WHO/EOP

cc:

Subject: weekly

September 10, 1998

MEMORANDUM FOR ERSKINE BOWLES, THE WHITE HOUSE

FROM: Robert E. Rubin

SUBJECT: Weekly Report for the week of September 14, 1998

HOT ISSUES

Japan

Ukraine

Financial Modernization

KEY NEWS

Japan: On September 4, Secretary Rubin met Japanese Finance Minister Miyazawa in San Francisco to discuss the economic situation in Japan, the United States, and the rest of the world. The two agreed on the importance of taking all possible steps to quickly resolve Japan's financial sector problems, including the use of sufficient public funds to restructure the banking system and protect depositors. Minister Miyazawa also outlined his government's plans to cut taxes and maintain fiscal expenditures at a high level next year. Secretary Rubin emphasized the importance of taking rapid action in both the banking and fiscal areas that is of sufficient magnitude to address the problems convincingly and

restore market confidence, and growth and stability to Japan's economy.

**Latin America:** On September 3, Secretary Rubin, Federal Reserve Vice Chair Rivlin, other Administration officials, and Finance Ministers and Central Bank governors from nine Latin American countries and Canada met in Washington with the heads of the IMF, World Bank, and Inter-American Development Bank. The officials discussed global economic turbulence and strategies to combat it. They agreed that the regions reforms of the past decade set it apart from other emerging markets and affirmed their commitment to economic reform, which they pledged to intensify in response to financial volatility. The International Monetary Fund agreed to strengthen its support for countries in the region, if necessary.

**Ukraine:** On September 4, the IMF approved a 3-year, \$2.2 billion Extended Fund Facility, which will lead to an immediate disbursement of \$257 million (increasing reserves from their current low level of \$700 million.) As part of the program, the IMF and Ukraine reached agreement that IMF funds will not be used to repay private creditors, which was a primary U.S. concern.

**Financial Modernization:** On September 9, Secretary Rubin released a statement reinforcing the Administrations position that the financial modernization bill will be vetoed, in part because of the Administrations concerns with elements of the bill which would undermine CRA. The statement was sent to all Senate Banking Committee members, House Banking members, and community groups. Treasury is continuing to educate community organizations about our position on the bill, and the consequences for low income communities, and is also working with Congress on proposals to reform the Home Loan Bank system as part of financial modernization. The Senate Banking Committee mark up of the financial modernization bill has been rescheduled for September 11 following the postponement of the September 3 markup because of disagreements among Senate Banking Committee Republicans relating to the Community Reinvestment Act.

**Suspicious Activity Reporting:** On September 9, Under Secretary Johnson spoke at Treasurys Financial Crimes Enforcement Network (FinCEN) public hearing in New York City. The hearing focused on FinCENs proposed rule for suspicious activity reporting for casinos and card clubs. The proposed rule represents a further step towards combating money laundering through effective administration and enforcement of the Bank Secrecy Act.

**Foreign Sales Corporations:** In the coming weeks, final regulations will be issued that resolve an issue of major concern to the software industry. Under these final regulations, a limitation on the foreign source income of a related supplier of a Foreign Sales Corporation (FSC) will affect only income from sales of export property. Therefore, the limitation will not apply to income from computer software licensing, which become eligible for treatment under the FSC rules as a result of the Tax Reform Act of 1997.

**Border Issues:** Treasury is working to develop a comprehensive economic profile of the U.S. Southern border region and a review of the relationship of the areas economic condition and crime for the Attorney Generals Southern Borders Conference in September.

## WORK ON PRESIDENTIAL INITIATIVES

**Presidents Working Group on Financial Markets:** On September 8, Secretary Rubin joined the other Principals of the Working Group on Financial Markets to discuss current market developments, global year 2000 preparedness, bank derivatives activity, and the Working Group study of the derivatives markets requested by Chairman Leach. The Principals directed staff to consult with Congress on the appropriate scope of the study.

**Race Initiative:** During August and September 1998, Treasury executives, managers and supervisors participated in the Computer-Based Training (CBT) pilots, during which the participants completed the CBT course, Management Aspects of EEO, and tested the on-line help system, EEO Assistant. Staff members are using the pilot feedback to make final revisions to the products, and distribution is planned for November 1998. Treasury managers and supervisors will be required to complete the course within eighteen months of its distribution. The on-line help system, EEO Assistant, will be loaded onto managers and supervisors desk top computers and will provide EEO information on an as needed basis.

**Medicare:** On September 8, the Medicare Commission held a public meeting to discuss interest-group recommendations for public reform, and also held a private meeting on September 9 to outline work for the next several months, leading up to the preparation of their report. Treasury is working with the White House, OMB, HHS, and HCFA staff on developing background evidence on the likely consequences of alternative Medicare reform proposals.

**Social Security:** On September 1, the Social Security Public Trustees held the final meeting in a series with outside experts to discuss the methods and assumptions used in preparing the annual Social Security and Medicare reports. The final meeting examined productivity growth and the real interest rate. The session on real interest rates focused on whether the Trustees projections for real rates are reasonable, and the panels consensus is that the Trustees real interest rate assumptions are consistent with historical values for real short-term interest rates and the yield spread on short and long-term securities.

**Welfare-to-Work:** Treasury continues working with the DPC and SBA to provide guidance on how businesses who hire recent welfare recipients can benefit from the welfare-to-work tax credit enacted last year. Treasury helped SBA respond to specific questions from several businesses in California and also initiated a guidance project with the IRS to provide information on the operation of the credit and the rules for eligibility.

**Climate Change:** On September 10, Deputy Secretary Summers joined Vice President Gore and Rep. Matsui at the White House to announce Rep. Matsui's introduction in the House of the Energy Efficient Technology Tax Act. The bill includes the Administration's FY '99 energy efficiency tax incentives package. The event was attended by Reps. Thurman, and McCarthy, congressional staff, and representatives of the business and

environmental communities. On September 9, Treasury officials met with representatives from the natural gas industry to discuss the Administration's climate change proposals. The American Gas Association and the Interstate Natural Gas Association were supportive of several provisions of the proposal and offered to work with us on the legislation.

Treasury continues to work with the State Department and other agencies to settle a number of unresolved issues that emerged from the Kyoto negotiations last December, including who would bear the risk of default when carbon permits are traded internationally: the buyer or the seller of the tainted permits. In addition, Treasury is working with CEA to provide analytical support for the upcoming climate change negotiations in Buenos Aires in November. Treasury officials participated in a delegation that visited China and Korea during the first week in September to encourage these countries to adopt targets and timetables for emissions reductions.

## CONGRESSIONAL ACTIVITY

**Tax:** On September 9, Secretary Rubin and OMB Director Lew met with Minority Leader Gephardt, and Reps. Rangel, Obey and Spratt to discuss an end-of-the-year legislative strategy with regard to appropriations and taxes. Rep. Gephardt's office indicated that they will pursue initiating a new Whip count in the House to see whether Members remain committed to voting against unpaid-for tax cuts. Treasury will work with Members to provide assistance to the committee or the Leadership.

**IMF:** On September 10, the House Appropriations Committee marked up the Foreign Operations FY99 bill. Rep. Pelosis amendments to increase IMF funding to the full \$18 billion and conditionality language were defeated 22-30 and 24-28, respectively. On September 2, the Senate passed their FY99 Foreign Operations bill 90-3 containing the full \$18 billion in funding for the IMF. The Senate Foreign Operations bill also contains \$47.5 million towards the \$192.5 million arrears request for funding for the Global Environment Facility (GEF), though the bill contained no funding towards the \$107.5 million annual commitment.

In anticipation of the House Foreign Operations Appropriations markup, Secretary Rubin sent the Speaker a letter on September 1 urging action on this legislation. Speaker Gingrich responded with a letter pointing out Congress concerns with recent developments in Russia and IMF reforms. On September 4, Secretary Rubin sent a second letter to Speaker Gingrich further explaining the Russia fiscal situation and addressing the Speakers concerns outlined in a letter to Rubin regarding the IMF and Russia. On September 9, Secretary Rubin discussed the IMF with Rep. Livingston and followed-up with a letter detailing the Administrations position and urging legislative action.

**Russia:** On September 10, Under Secretary Lipton testified before the House Banking Subcommittee on General Oversight and Investigations on the Russia IMF program. Under Secretary Lipton was praised by the Members for his frank and honest answers. Most of the Members comments suggested that they laid most of the blame on the Russians, some on the IMF, while acknowledging that the U.S. has to stay engaged with Russia. The debate

centered around how much reform is needed before re-engaging, where the past assistance went, and concerns with the IMF program in Russia. On September 16, Secretary Rubin will testify before the House Banking Committee on the global economic and financial situation. On September 17, Deputy Secretary Summers will testify before the House International Relations Committee on the IMF program in Russia. Deputy Secretary Summers will also speak at the Senate Democratic Policy Committee lunch on September 17 on the Russian economic situation issue.

**NADBank:** The House Appropriations Committee approved a Foreign Operations bill without funding for the NADBank/CAIP. Treasury will continue to work with key Members in achieving funding in the Conference to the Foreign Operations bill.

**Treasury Appropriations:** On September 3, the Senate passed the Treasury-Postal Appropriations bill with a 91-5 vote. Treasury will now focus on securing Y2K funding in conference.

**Bankruptcy:** The Senate continues its consideration of the Grassley-Durbin consumer bankruptcy bill, and the prospects for passage are good. On September 10, Treasury, the NEC, Justice, and Majority and Minority staff of the Judiciary Committee participated in negotiations over amendments that would incorporate Democratic concerns to the bill, such as Sen. Durbin's efforts to make credit card companies more responsible for poor lending practices and to give child support and alimony debts priority over other liabilities.

## PRESS ACTIVITY

**International:** On September 1, Assistant Secretary Geithner and Chief of Staff Froman spoke with Fortune Magazine on Treasurys role in managing the Asian financial situation. On September 2, Assistant Secretary Geithner spoke with Japanese newspapers about the San Francisco meeting. On September 4, Secretary Rubin met with Japanese Finance Minister Miyazawa in San Francisco and participated in a press conference following the meeting. There were over 100 members of the media at the press conference. Secretary Rubin also did live interviews with CNN Moneyline and Nightly Business Report about the meeting.

**Tax and Budget:** On August 31, Deputy International Tax Counsel Brown spoke with Reuters regarding the U.S. -Venezuela Income Tax Treaty. On September 1, Deputy Assistant Secretary McClellan spoke with the White House Bulletin regarding the Treasury Departments participation in CHIP Initiative. On September 3, Deputy International Tax Counsel Brown spoke with Petroleum Argus Magazine regarding U.S. -Venezuela Income Tax Treaty and Benefits Tax Counsel Iwry spoke with Investors Business Daily regarding Roth IRA Conversions. On September 10, Assistant Secretary Wilcox is scheduled to meet with Susan Dentzer from the Lehrer NewsHour to discuss Social Security.

**Domestic Finance:** On September 2, Under Secretary Hawke spoke with American Banker on financial modernization, detailing Treasurys opposition to the legislation. On September 4, Director of the Office of Cash and Debt Management Munroe spoke with the Washington Post, explaining



statistics describing the governments daily cash flow. The article is a follow-up to a 1996 article comparing how much the government takes in and spends to the executive branches payroll.

Enforcement: On September 2, Customs Commissioner Kelly held a press conference announcing Customs role in raids on members of an international Internet child pornography ring. Announcements were held in several of the 12 other countries that executed search warrants and made arrests. All major and regional print and broadcast media led with the story and Kelly did a live interview on CNN International. On September 4, OFAC Director Newcomb spoke with Kevin Hall, Journal of Commerce, about Treasury/States denial of a license to Alamar Associates for a proposed business summit in Cuba. Public Affairs provided background interviews to the Associated Press, National Public Radio, Washington Times, Agence France-Presse, Miami Herald, Ft. Lauderdale Sun-Sentinel and the Dallas Morning News.

## SECRETARYS SCHEDULE

### The Week in Review

Monday, September 7, 1998

Labor Day - Federal Holiday

Tuesday, September 8, 1998

Met with George Becker, United Steelworkers of America

Met with Senate Democratic Caucus

Attended the Working Group on Financial Markets Principals Meeting

Wednesday, September 9, 1998

Met with Dr. Neal Lane, White House Office of Science and Technology

Met with Chairman Greenspan

Met with representatives of the steel industry to discuss trade issues

Met with Reps. Gephardt, Rangel, Spratt, and Obey to discuss budget priorities

Interviewed by David Wessell and Bob Davis, Wall Street Journal

Thursday, September 10, 1998

Met with Vice President Gore to discuss Japan

Met with American Farm Bureau representatives to discuss IMF funding, Fast Track and other international issues

Attended the Presidents Clintons Cabinet Meeting

Friday, September 10, 1998

Met with Ambassador Barshefsky to discuss Japan

## The Week Ahead

Monday, September 14, 1998

Will attend President Clintons economic speech in New York  
Will travel to Charlotte, North Carolina to address the Charlotte Chamber of Commerce with Rep. Mel Watt

Tuesday, September 15, 1998

No external meetings

Wednesday, September 16, 1998

Will attend Business Roundtable Breakfast (BRT)  
Will meet with General McCaffrey to discuss FY 99 funding for the ONDCP  
Will meet with BRT Policy Committee.  
Will testify on the global economic situation before the House Banking Committee.

Thursday, September 17, 1998

Breakfast with Chairman Greenspan  
Will host a CEO lunch

Friday, September 18, 1998

No external schedule

ARMS Email SystemRECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Ruby Shamir ( CN=Ruby Shamir/OU=WHO/O=EOP [ WHO ] )

CREATION DATE/TIME:14-SEP-1998 16:11:16.00

SUBJECT: 1998-09/14 POTUS remarks to council on foreign relations

TO: Jackson T. Dunn ( CN=Jackson T. Dunn/OU=WHO/O=EOP @ EOP [ WHO ] )

READ:UNKNOWN

TEXT:

----- Forwarded by Ruby Shamir/WHO/EOP on 09/14/98 04:08  
PM -----

OLCOTT\_E @ A1

09/14/98 03:54:00 PM

Record Type: Record

To: See the distribution list at the bottom of this message

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Subject: 1998-09/14 POTUS remarks to council on foreign relations

THE WHITE HOUSE

Office of the Press Secretary  
(New York, New York)

For Immediate Release  
1998

September 14,

REMARKS BY THE PRESIDENT  
TO THE COUNCIL ON FOREIGN RELATIONS

Council on Foreign Relations Building  
New York, New York

12:00 P.M. EDT

THE PRESIDENT: Thank you very much, Pete. Hillary and I  
are  
delighted to be here with you and Joan, and I'm glad to be joined by  
Secretary  
Rubin and Jim Harmon, Gene Sperling, other members of our team. I'm glad  
to

see Dick Holbrooke over here. I hope, if we can overcome the inertia of Congress, he will soon be a member of the team again. (Applause.) And I thank David Rockefeller and Les Gelb and others who welcomed us here today.

The subject that I want to discuss -- let me just say one thing in advance -- I'm going to give you my best thoughts. We have been working on this for three years at some level of intensity or another, going back to the Naples G-7 meeting in the aftermath of the Mexican financial crisis. I have done everything I could do personally to reach out across the country, and indeed across the world, for any new ideas from any source. I'm going to give you my best thinking today about what we can do, but I want you to know that I'm here, and if I had my druthers, this would be about a three-hour session where I'd give this talk and then I would listen for the rest of the time.

So I want to encourage you, if you think we're right, to support us. But if you have any ideas, for goodness sake, share them, because I agree with what Pete said: this is the biggest financial challenge facing the world in a half-century. And the United States has an absolutely inescapable obligation to lead, and to lead in a way that's consistent with our values and our obligation to see that what we're doing helps lift the lives of ordinary people here at home and all around the world.

The Council on Foreign Relations has always stood for political and economic freedom, since right after World War I. And I think one of the things that has impacted all of us, and it was implicit in what Pete said, is that for the last decade the growth of freedom around the world, with more than half the people in the world living under governments of their own choosing, more than half the villages, the one million villages in China now, even electing their own governments, and this sweeping replacement of command and control economies by market economies. I think it seems to have happened so easily, so effortlessly, so inexorably, that I think we think the trend is inevitable and irreversible.

But if you consider today's economic difficulties, disruptions, and the plain old, deep, personal disappointments of now tens of millions of people around the world, it is clear to me that there is now a stark challenge not only to economic freedom, but, if unaddressed, a challenge

that could stem the rising tide of political liberty as well.

Obviously we have profound interests here. It is a great irony that we are at a moment of unsurpassed economic strength at a time of such turmoil in the world economy. We, I think all of us in this room, know that our future prosperity depends upon whether we can work with others to restore

confidence, manage change, stabilize the financial system, and spur robust global growth.

For most of the last 30 years, the United States and the rest of the world has been preoccupied by inflation, for reasons that all of you here know all too well -- and it was a good thing to be preoccupied with. Today the low and stable inflation we enjoy has been critical to our economic health, and low inflation has also contributed to that of many other nations as well. But clearly the balance of risks has now shifted, with a full quarter of the world's population living in countries with declining economic growth or negative economic growth.

Therefore, I believe the industrial world's chief priority today, plainly, is to spur growth. It seems to me there are six immediate steps we should take to help contain the current financial turmoil around the world, and then two longer-term projects in which we must be involved.

To take the immediate first, we must work with Japan, Europe, and other nations to spur growth. Second, we will expand our efforts to enable viable businesses in Asia to emerge from crippling debt burdens so they can once again contribute to growth and job creation. Third, we've asked the World Bank to double its support for the social safety net in Asia to help people who are innocent victims of financial turmoil. Fourth, we'll urge the major industrial economies to stand ready to use the \$15 billion in IMF emergency funds to help stop the financial contagion from spreading to Latin America and elsewhere. Fifth, our Ex-Im Bank, under the leadership of Jim Harmon, will intensify its efforts to generate economic activity in the developing world immediately, in the next three months. And sixth, Congress must live up to its responsibility for continued prosperity by meeting our obligations to the International Monetary Fund.

Secretary Rubin has been working with his counterparts in the G-7 to get cooperative support for several of these measures. I understand Chairman Greenspan is also consulting with his counterparts on these items as well.

As we take these immediate steps, we also must intensify our efforts to reform our trade and financial



institutions so that they can respond better to the challenges we now face and those we are likely to face in the future. We must build a stronger and more accountable global trading system, pressing forward with market-opening initiatives, but also advancing the protection of labor and environmental interests, and doing more to ensure that trade helps the lives of ordinary citizens across the globe.

Above all, we must accelerate our efforts to reform the international financial system. Today I have asked Secretary Rubin and Federal Reserve Board Chairman Greenspan to convene a major meeting of their counterparts within the next 30 days to recommend ways to adapt the international financial architecture to the 21st century.

Over the past six years, our strategy at home of fiscal discipline, investment in the skills of our people, and open trade has worked for all Americans. Unemployment at a 28-year low, inflation a 32-year low, wages rising at twice the rate of inflation after decades of stagnation. And on October 1st we'll have the first balanced budget in 29 years.

But the global economy brought a lot of that prosperity to us, and now fast-moving currents have brought or aggravated problems in Russia and Asia. They threaten emerging economies from Latin America to South Africa. With a quarter of the world's population in declining growth, we must recognize what Chairman Greenspan said the other day: we cannot forever be

an oasis of prosperity. Growth at home depends upon growth abroad. A full 30 percent of our growth, just since I became President, has been due to our expanding positive involvement in the global economy.

That's why ordinary Americans should care if Asia or Russia or South America is on solid economic footing. These people are our customers. With one-third of the growth of our economy coming from exports, much of it from emerging markets, we know that those markets will falter as their economies flatten. When the problem is widespread and perceived to be moving in the wrong direction, we have seen that our stock market can react, having a direct and immediate impact on the wealth of the American people.

These nations are also our competitors. And under conditions of decent equilibrium that is a very good thing, indeed. But when their currencies drop precipitously, the prices of their goods fall, they could undercut the sales of our own goods here at home that are otherwise profitable, dramatically increasing our trade deficit under circumstances that could cause the American people to turn away from open trade toward protectionism in a way that has terrific negative consequences long-term for our global growth objectives.

Finally, these nations are our friends, our allies and our security partners. Where economic turmoil plunges millions into sudden poverty and disrupts and disorients the lives of ordinary people, the risks of political and social instability and of a turn from democracy clearly rise. Just look at Russia. Russia is facing an economic crisis that threatens the extraordinary progress the Russian people have made in just seven years, building a new society from the ground up. The ruble and the stock market have plummeted, banks are weak, tax collections have slowed, the government has trouble paying its debts and its salaries.

Some Russians have become wealthy, but many, many more are struggling to provide for their families. I talked to some of them when I was in Russia just a few days ago.

Amid such political uncertainty and economic difficulty, some now talk of abandoning the path of reform and returning to policies of the past, even policies that have already failed. At worst, adversity in Russia could affect not only the Russian economy and prospects for our economic cooperation -- at worst, it could have an impact on our cooperation with Russia on nuclear disarmament, on fighting terrorism and the spread of weapons of mass destruction, on standing together for peace, from the Balkans to the Middle East.

Now Russia has a new Prime Minister, Mr. Primakov, who's been in office a grand total of four days. He and President Yeltsin face one of the great challenges of their time. Never has there been a more important moment to set a clear direction for the future, to affirm the commitment of Russia to democracy and to free markets, and to take decisive steps to stabilize the economy and restore investor confidence.

But if Russia is willing to take these steps, we must do everything we can to provide support to them. Because again I say, as long as ordinary people don't feel any benefits from this, in the end it's going to be difficult to sustain the direction we think the world should take.

On the other hand, we need to be honest with Russia and everyone else. No nation, rich or poor, democratic or authoritarian, can escape the fundamental economic imperatives of the global market. No nation can escape its discipline. No nation can avoid its responsibility to do its part.

But since all economies are increasingly interdependent, fear and uncertainty about the economy of one country can prompt investors to pull money out of other countries thousands of miles away. Markets work best when they are driven neither by excessive inflows or outflows of capital based on

indiscriminate optimism or pessimism.

Regardless of what changes in policies or institutions may be warranted, we have to say we'll only be able to help those countries who are willing to help themselves. If a nation chooses to print money indiscriminately, to wink at cronyism or corruption, to hide bad loans and protect corrupt or inefficient banks, then investors, foreign and domestic, sooner or later, will withdraw their investments, with consequences both swift and severe.

That is why we support the fundamental approach of the International Monetary Fund to extend assistance only when nations have taken responsibility, strengthening their banking systems, introducing honest accounting and open markets, awarding credit on merit instead of connections.

Still, what has been done is clearly not enough to reverse the decline in particular countries, to douse the flames of the international financial crisis, to support steady and sustainable growth in the future. In the face of this new challenge, America can and must continue to act and to lead to take the urgent steps needed today to calm the financial crisis, restart the engine of growth in Asia, and minimize the impact of financial turmoil on other nations, and to make certain that for tomorrow the institutions and rules of international finance and international trade are prepared to support steady and sustainable growth over the long term.

First and foremost, the leading economic nations must act together to spur global growth. Our strong and growing economy here has made a major contribution to global growth, just as our weak economy was holding the world back six years ago when I attended my first G-7 meeting in Tokyo and every other country said, the first thing they needed was for America to put its economic house in order. We did that.

Now I believe strongly we must maintain our fiscal discipline. It has led to lower interest rates and a huge investment and job growth. Maintaining economic growth is the best thing we can do right now, not only for the United States but for the global economy.

I would also remember that back in 1993 we had a general agreement that what was needed was America should get rid of its deficit, Europe should lower its interest rates, and Japan should open its markets. There was this general agreement that if we did all those things, we would have a remarkable resumption of growth.

Europe did moderate its interest rates and the then prime minister -- now the finance minister -- Mr. Miyazawa, oversaw a significant market opening trade agreement between the United States and Japan, which also benefited others, not just

us. And of course we got rid of our deficit. The results were quite satisfactory for several years for us.

Now Europe has to continue to pursue policies that will spur growth and keep their markets open because they, too, must be able to provide markets for Asian goods as those nations seek to find their footing. But the key here is Japan, for the second largest economy in the world, by far the biggest economy in Asia, has now gone several years without any economic growth. Thank goodness, a lot of their ordinary citizens have been able to maintain a decent life because of the wealth of their country and probably because of the enormous personal savings rate they

have enjoyed for many, many years now.

But it is difficult to see how any actions of the world community can be successful in restoring growth in Asia in the absence of the restoration of growth in Japan, which would enable Japan to lead the region out of its present condition. Therefore, we must support Japan and do everything we can to help create the conditions in which, together, we can all lead again, just as we did in 1993.

Their challenges are quite formidable. They have to spur domestic demand, revive a banking system, restore confidence, deregulate the economy, and open markets. And we all know all the forces that seem to be working against these developments in Japan. But I would remind you that this is a very strong, sophisticated nation full of people of knowledge and enormous achievement. It is fully capable of playing its world leadership role. I believe its business leaders right now know what needs to be done and would support it.

Next week I'm going to meet with Prime Minister Obuchi here in New York to discuss how America can support Japan's efforts to restore economic growth and investor confidence. And I will do everything I can to try to make sure that as we go forward, we have America, Europe, and Japan all doing our part to get beyond this present moment, just as we did back in 1993.

The second step we should take is to intensify our efforts to speed economic recovery in Asia. When countries like South Korea and Thailand have taken strong and responsible steps, the freefall has ended, progress is being made. But the human cost of Asia's collapse is only now being fully felt. Recent press reports have described an entire generation working its way into the middle class over 25 years, then being plummeted into poverty within a matter of months. The stories are heartbreaking -- doctors and nurses forced to live in the lobby of a closed hospital; middle class families who own their own homes, sent their children to college, traveled abroad, now living by selling their possessions.

It is in our interest to help these nations and these people recover. They will become once again our great markets and our great partners. It is also the right thing to do. We've worked with international lenders, like the IMF, to help these nations to adopt pro-growth budget, tax, and monetary policies, but clearly we're going to have to do more to restore Asian growth. We must work to lift the weight of private sector debt that has frozen the Asian economies.

Today, I'm asking Secretary Rubin to work with other financial authorities and international economic institutions to enhance efforts to explore comprehensive plans to help Asian corporations emerge from massive debt where individual firms have been swept under by systemic, national economic problems, rather than their own errors. We need to get credit flowing again. We need to get business back to making products, producing services, creating jobs.

Third, Asian businesses need assistance, but so do millions of Asian families. We must do more to establish an adequate social safety net in recovering nations. Wrenching economic transition without an adequate social safety net can sacrifice lives in the name of economic theory, and, I might add, can generate thereby so much resistance that reform grinds to a halt. If we want these countries to do tough things, we have to protect the most defenseless people in the society and we have to protect people who get hurt when they didn't do anything wrong. I think that is terribly important.

With our support, the World Bank and the Asian

Development Bank have started to deal with these challenges, but they have to expand their efforts. There is simply not enough being done. I asked them to double their aid through an expanded social compact initiative focusing on job assistance, basic needs and economic transition, on children and the elderly, on groups most vulnerable to economic change. And I want to commend Jim Wolfensohn for his efforts and his willingness to lead this expanded initiative. We have to be ready to respond immediately with financial force if necessary, to the currency crisis, if it spreads, especially if it threatens the economies of Latin America, where nations have struggled to make progress to do the right thing, only to find themselves buffeted by economic storms outside their control.

Therefore, the major economies should stand ready to activate the \$15 billion now in the emergency funds of the IMF, the general agreement to borrow, to ensure that the IMF continues to support reform and fight economic contagion.

Fifth, our Export-Import Bank will increase its commitments to specific economic development projects over the



next three years -- three months -- projects which will have concrete benefits for ordinary citizens in other countries, projects which will increase our own exports and thereby help our economy, and ones which can help to restore confidence in countries that they are not alone and that actual, specific, positive developments can occur.

Sixth, for the effort of the international community to succeed, America simply must meet its own obligations to the International Monetary Fund. After a year of financial firefighting, the IMF's resources are badly strained. Every day we don't act, we undermine the confidence the world badly needs that we are trying to restore. Congress simply must assume its responsibility for our leadership in the economy.

In my State of the Union address, I said it was better to prepare for a storm when the skies were clear than when the clouds were overhead. Well, eight months later, the clouds are closer, and you can nearly hear the thunder. Now, the Senate, by an overwhelming bipartisan majority, has, thankfully, approved our obligation to fund our part of the International Monetary Fund. But with only five weeks left in this congressional session, there is still no action from the House of Representatives.

Let me put this as plainly as I can: failure by this Congress to pay our dues to the IMF will put our own prosperity at risk. Failure to act will send a sharp signal that at a time of economic challenge, our lawmakers were unwilling to protect our workers, our businesses, our farmers from the risks of global economic change, and unwilling to maintain our leadership in building a global economy system that has benefited us more than any other nation.

Concerted action to spur growth, helping Asia through private sector debt restructuring, and a strengthened social safety net, helping to protect the rest of the world through the use of the IMF's emergency fund, increasing the activity of the Ex-Im Bank, and meeting our own obligations to the IMF -- these are the six immediate steps we want to take.

But we must also be willing to take action for the long run -- to modify the financial and trading institutions of the world to match the realities of the new economy they serve. By creating the WTO, the World Trading Organization, in 1994, we began to build a modern trading system. We must redouble our efforts to tear down barriers around the world. But as I said in Geneva last May, we must do more to ensure that spirited economic competition among nations never becomes a race to the bottom -- in environmental protection, consumer protection, or labor

standards.

We are working to open the procedures of the WTO to participation by the public and the full range of affected interests, so that people will know and see and be able to do for themselves things which will ensure that the trading system makes the world better for all the people in all the countries.

We've already completed 260 trade agreements, opening markets in areas from autos to telecommunications. Next year we will host the meeting of the world's trade ministers to set the agenda for expanded trade in the first decade in the new century.

History teaches us that at a time of worldwide difficulty, it would be folly to retreat into a protectionist shell. We must keep trade flowing among nations, but I will say again, if we want to do that, we have got to give ordinary citizens and the groups that represent them in countries all over the world the sense that it is going to be done in a fair way, consistent with nations' obligations to advance the interests of their working people and protect not only their national, but the global environment.

This November, when I meet with the leaders of the Asian economies at the APEC meeting, we will move forward to further open markets in Asia. And when Congress returns next year, I will work to pass legislation to open markets further --from trade negotiating powers to the African Trade Initiative. I will do so in a way that I believe will win broad support from a majority of both parties.

From the G-7 meeting in Halifax in 1995 in the wake of the Mexican financial crisis, to the Birmingham meeting this year, we have been working, also, with our major economic partners to plan for new financial architecture for the 21st century.

For the first time, this year we included key emerging markets in the process in a new Group of 22, recognizing their important stake in the global economy. This group has been working together for nearly a year now to improve the global financial assistance with a special focus on improving financial sectors, on transparency, and on private sector burden sharing.

I just want to emphasize again that even as we respond to the urgent alarms of the moment, we must speed the pace of this systemic work as well. That is why I have asked Secretary Rubin and Chairman Greenspan to convene the finance ministers and central bankers of the G-7 and key emerging economies in Washington within 30 days to develop a preliminary report to the heads of state by the beginning of next year on strengthening the world financial system.

We must develop policies so that countries can reap the benefits of free-flowing capital in a way that is safe and

sustainable. We must adapt the IMF so that it can more effectively confront the new types of financial crises, minimizing their frequency, severity, and human cost. We need to consider ways to extend emergency financing when countries are battling crises of confidence due to world financial distress as distinct from their own errors in policy. We must find ways to tap the energy of global markets without sentencing the world to a cycle of continued extreme crises.

For half a century now in our national economy, we have learned not to eliminate but to tame and limit the swings of boom and bust. In the 21st century, we have to find a way to do that in the global economy as well.

I've discussed this in recent days with Prime

Minister Blair of Great Britain, who is now the Chair of the G-7. He shares my belief that this is an urgent task. It is critical to the mission that he and I and Prime Minister Prodi of Italy will be discussing next week at the New York University Law School in a very interesting meeting that the First Lady and others in our administration helped to organize on how to extend

the benefits of the world economy to all and how to strengthen democracy in a time of such sweeping economic change.

Now, let me just say it all again very briefly: in short, we must improve our ability to address the current financial emergency, and we must build a system to prevent such future emergencies, whenever possible, and to blunt their impact when they do occur. There is no mission more critical to our own strength and security.

And let me say this again, what is at stake is more than the spread of free markets and their integration into the global economy. The forces behind the global economy are also those that deepen democratic liberties: the free flow of ideas and information, open borders and easy travel, the rule of law, fair and even-handed enforcement, protection for consumers, a skilled and educated work force.

Each of these things matters not only to the wealth of nations but to the health of freedom. If citizens tire of waiting for democracy and free markets to deliver a better life for them, there is a real risk that democracy and free markets, instead of continuing to thrive together, will begin to shrivel together. This would pose great risks not only for our economic interests but for our security.

We see around the world the international aggressors, the harborers of terrorists, the drug lords. Who are these countries? They're authoritarian nations without democracy

and without open markets. Nations that give their people freedom are good neighbors; when nations turn away from freedom, they turn inward toward tension, hatred, and hostility.

We now have a chance to create opportunity on a worldwide scale. The difficulties of the moment should not obscure us to the advances of the last several years. We clearly have it within our means, if we do the right things, to lift billions and billions of people around the world into a global middle class and into participation in global democracy and genuine efforts toward peace and reconciliation. That is a possibility, but recent events show it is not a certainty.

At this moment, therefore, the United States is called upon once again to lead -- to organize the forces of a committed world; to channel the unruly energies of the global economy into positive avenues; to advance our interests, reinforce our values, enhance our security.

In this room, I think it is not too simple to say we know what to do. The World War II generation did it for us 50 years ago. Now, it is time for us to rise to our responsibility, as America has called upon to do so often so many times in the past. We can, if we do that, redeem the promise of the global economy and strengthen our own nation for a new century.

Thank you very much. (Applause.)

END

12:34 P.M. EDT

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THE WHITE HOUSE

Office of the Press Secretary  
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For Immediate Release  
1998

September 14,

REMARKS BY THE PRESIDENT  
TO THE COUNCIL ON FOREIGN RELATIONS

Council on Foreign Relations Building  
New York, New York

12:00 P.M. EDT

THE PRESIDENT: Thank you very much, Pete. Hillary and I  
are  
delighted to be here with you and Joan, and I'm glad to be joined by  
Secretary  
Rubin and Jim Harmon, Gene Sperling, other members of our team. I'm glad  
to

see Dick Holbrooke over here. I hope, if we can overcome the inertia of Congress, he will soon be a member of the team again. (Applause.) And I thank David Rockefeller and Les Gelb and others who welcomed us here today.

The subject that I want to discuss -- let me just say one thing in advance -- I'm going to give you my best thoughts. We have been working on this for three years at some level of intensity or another, going back to the Naples G-7 meeting in the aftermath of the Mexican financial crisis. I have done everything I could do personally to reach out across the country, and indeed across the world, for any new ideas from any source. I'm going to give you my best thinking today about what we can do, but I want you to know that I'm here, and if I had my druthers, this would be about a three-hour session where I'd give this talk and then I would listen for the rest of the time.

So I want to encourage you, if you think we're right, to support us. But if you have any ideas, for goodness sake, share them, because I agree with what Pete said: this is the biggest financial challenge facing the world in a half-century. And the United States has an absolutely inescapable obligation to lead, and to lead in a way that's consistent with our values and our obligation to see that what we're doing helps lift the lives of ordinary people here at home and all around the world.

The Council on Foreign Relations has always stood for political and economic freedom, since right after World War I. And I think one of the things that has impacted all of us, and it was implicit in what Pete said, is that for the last decade the growth of freedom around the world, with more than half the people in the world living under governments of their own choosing, more than half the villages, the one million villages in China now, even electing their own governments, and this sweeping replacement of command and control economies by market economies. I think it seems to have happened so easily, so effortlessly, so inexorably, that I think we think the trend is inevitable and irreversible.

But if you consider today's economic difficulties, disruptions, and the plain old, deep, personal disappointments of now tens of millions of people around the world, it is clear to me that there is now a stark challenge not only to economic freedom, but, if unaddressed, a challenge



that could stem the rising tide of political liberty as well.

Obviously we have profound interests here. It is a great irony that we are at a moment of unsurpassed economic strength at a time of such turmoil in the world economy. We, I think all of us in this room, know that our future prosperity depends upon whether we can work with others to restore

confidence, manage change, stabilize the financial system, and spur robust global growth.

For most of the last 30 years, the United States and the rest of the world has been preoccupied by inflation, for reasons that all of you here know all too well -- and it was a good thing to be preoccupied with. Today the low and stable inflation we enjoy has been critical to our economic health, and low inflation has also contributed to that of many other nations as well. But clearly the balance of risks has now shifted, with a full quarter of the world's population living in countries with declining economic growth or negative economic growth.

Therefore, I believe the industrial world's chief priority today, plainly, is to spur growth. It seems to me there are six immediate steps we should take to help contain the current financial turmoil around the world, and then two longer-term projects in which we must be involved.

To take the immediate first, we must work with Japan, Europe, and other nations to spur growth. Second, we will expand our efforts to enable viable businesses in Asia to emerge from crippling debt burdens so they can once again contribute to growth and job creation. Third, we've asked the World Bank to double its support for the social safety net in Asia to help people who are innocent victims of financial turmoil. Fourth, we'll urge the major industrial economies to stand ready to use the \$15 billion in IMF emergency funds to help stop the financial contagion from spreading to Latin America and elsewhere. Fifth, our Ex-Im Bank, under the leadership of Jim Harmon, will intensify its efforts to generate economic activity in the developing world immediately, in the next three months. And sixth, Congress must live up to its responsibility for continued prosperity by meeting our obligations to the International Monetary Fund.

Secretary Rubin has been working with his counterparts in the G-7 to get cooperative support for several of these measures. I understand Chairman Greenspan is also consulting with his counterparts on these items as well.

As we take these immediate steps, we also must intensify our efforts to reform our trade and financial

institutions so that they can respond better to the challenges we now face and those we are likely to face in the future. We must build a stronger and more accountable global trading system, pressing forward with market-opening initiatives, but also advancing the protection of labor and environmental interests, and doing more to ensure that trade helps the lives of ordinary citizens across the globe.

Above all, we must accelerate our efforts to reform the international financial system. Today I have asked Secretary Rubin and Federal Reserve Board Chairman Greenspan to convene a major meeting of their counterparts within the next 30 days to recommend ways to adapt the international financial architecture to the 21st century.

Over the past six years, our strategy at home of fiscal discipline, investment in the skills of our people, and open trade has worked for all Americans. Unemployment at a 28-year low, inflation a 32-year low, wages rising at twice the rate of inflation after decades of stagnation. And on October 1st we'll have the first balanced budget in 29 years.

But the global economy brought a lot of that prosperity to us, and now fast-moving currents have brought or aggravated problems in Russia and Asia. They threaten emerging economies from Latin America to South Africa. With a quarter of the world's population in declining growth, we must recognize what Chairman Greenspan said the other day: we cannot forever be

an oasis of prosperity. Growth at home depends upon growth abroad. A full 30 percent of our growth, just since I became President, has been due to our expanding positive involvement in the global economy.

That's why ordinary Americans should care if Asia or Russia or South America is on solid economic footing. These people are our customers. With one-third of the growth of our economy coming from exports, much of it from emerging markets, we know that those markets will falter as their economies flatten. When the problem is widespread and perceived to be moving in the wrong direction, we have seen that our stock market can react, having a direct and immediate impact on the wealth of the American people.

These nations are also our competitors. And under conditions of decent equilibrium that is a very good thing, indeed. But when their currencies drop precipitously, the prices of their goods fall, they could undercut the sales of our own goods here at home that are otherwise profitable, dramatically increasing our trade deficit under circumstances that could cause the American people to turn away from open trade toward protectionism in a way that has terrific negative consequences long-term for our global growth objectives.

Finally, these nations are our friends, our allies and our security partners. Where economic turmoil plunges millions into sudden poverty and disrupts and disorients the lives of ordinary people, the risks of political and social instability and of a turn from democracy clearly rise. Just look at Russia. Russia is facing an economic crisis that threatens the extraordinary progress the Russian people have made in just seven years, building a new society from the ground up. The ruble and the stock market have plummeted, banks are weak, tax collections have slowed, the government has trouble paying its debts and its salaries.

Some Russians have become wealthy, but many, many more are struggling to provide for their families. I talked to some of them when I was in Russia just a few days ago.

Amid such political uncertainty and economic difficulty, some now talk of abandoning the path of reform and returning to policies of the past, even policies that have already failed. At worst, adversity in Russia could affect not only the Russian economy and prospects for our economic cooperation -- at worst, it could have an impact on our cooperation with Russia on nuclear disarmament, on fighting terrorism and the spread of weapons of mass destruction, on standing together for peace, from the Balkans to the Middle East.

Now Russia has a new Prime Minister, Mr. Primakov, who's been in office a grand total of four days. He and President Yeltsin face one of the great challenges of their time. Never has there been a more important moment to set a clear direction for the future, to affirm the commitment of Russia to democracy and to free markets, and to take decisive steps to stabilize the economy and restore investor confidence.

But if Russia is willing to take these steps, we must do everything we can to provide support to them. Because again I say, as long as ordinary people don't feel any benefits from this, in the end it's going to be difficult to sustain the direction we think the world should take.

On the other hand, we need to be honest with Russia and everyone else. No nation, rich or poor, democratic or authoritarian, can escape the fundamental economic imperatives of the global market. No nation can escape its discipline. No nation can avoid its responsibility to do its part.

But since all economies are increasingly interdependent, fear and uncertainty about the economy of one country can prompt investors to pull money out of other countries thousands of miles away. Markets work best when they are driven neither by excessive inflows or outflows of capital based on

indiscriminate optimism or pessimism.

Regardless of what changes in policies or institutions may be warranted, we have to say we'll only be able to help those countries who are willing to help themselves. If a nation chooses to print money indiscriminately, to wink at cronyism or corruption, to hide bad loans and protect corrupt or inefficient banks, then investors, foreign and domestic, sooner or later, will withdraw their investments, with consequences both swift and severe.

That is why we support the fundamental approach of the International Monetary Fund to extend assistance only when nations have taken responsibility, strengthening their banking systems, introducing honest accounting and open markets, awarding credit on merit instead of connections.

Still, what has been done is clearly not enough to reverse the decline in particular countries, to douse the flames of the international financial crisis, to support steady and sustainable growth in the future. In the face of this new challenge, America can and must continue to act and to lead to take the urgent steps needed today to calm the financial crisis, restart the engine of growth in Asia, and minimize the impact of financial turmoil on other nations, and to make certain that for tomorrow the institutions and rules of international finance and international trade are prepared to support steady and sustainable growth over the long term.

First and foremost, the leading economic nations must act together to spur global growth. Our strong and growing economy here has made a major contribution to global growth, just as our weak economy was holding the world back six years ago when I attended my first G-7 meeting in Tokyo and every other country said, the first thing they needed was for America to put its economic house in order. We did that.

Now I believe strongly we must maintain our fiscal discipline. It has led to lower interest rates and a huge investment and job growth. Maintaining economic growth is the best thing we can do right now, not only for the United States but for the global economy.

I would also remember that back in 1993 we had a general agreement that what was needed was America should get rid of its deficit, Europe should lower its interest rates, and Japan should open its markets. There was this general agreement that if we did all those things, we would have a remarkable resumption of growth.

Europe did moderate its interest rates and the then prime minister -- now the finance minister -- Mr. Miyazawa, oversaw a significant market opening trade agreement between the United States and Japan, which also benefited others, not just

us. And of course we got rid of our deficit. The results were quite satisfactory for several years for us.

Now Europe has to continue to pursue policies that will spur growth and keep their markets open because they, too, must be able to provide markets for Asian goods as those nations seek to find their footing. But the key here is Japan, for the second largest economy in the world, by far the biggest economy in Asia, has now gone several years without any economic growth. Thank goodness, a lot of their ordinary citizens have been able to maintain a decent life because of the wealth of their country and probably because of the enormous personal savings rate they

have enjoyed for many, many years now.

But it is difficult to see how any actions of the world community can be successful in restoring growth in Asia in the absence of the restoration of growth in Japan, which would enable Japan to lead the region out of its present condition. Therefore, we must support Japan and do everything we can to help create the conditions in which, together, we can all lead again, just as we did in 1993.

Their challenges are quite formidable. They have to spur domestic demand, revive a banking system, restore confidence, deregulate the economy, and open markets. And we all know all the forces that seem to be working against these developments in Japan. But I would remind you that this is a very strong, sophisticated nation full of people of knowledge and enormous achievement. It is fully capable of playing its world leadership role. I believe its business leaders right now know what needs to be done and would support it.

Next week I'm going to meet with Prime Minister Obuchi here in New York to discuss how America can support Japan's efforts to restore economic growth and investor confidence. And I will do everything I can to try to make sure that as we go forward, we have America, Europe, and Japan all doing our part to get beyond this present moment, just as we did back in 1993.

The second step we should take is to intensify our efforts to speed economic recovery in Asia. When countries like South Korea and Thailand have taken strong and responsible steps, the freefall has ended, progress is being made. But the human cost of Asia's collapse is only now being fully felt. Recent press reports have described an entire generation working its way into the middle class over 25 years, then being plummeted into poverty within a matter of months. The stories are heartbreaking -- doctors and nurses forced to live in the lobby of a closed hospital; middle class families who own their own homes, sent their children to college, traveled abroad, now living by selling their possessions.



It is in our interest to help these nations and these people recover. They will become once again our great markets and our great partners. It is also the right thing to do. We've worked with international lenders, like the IMF, to help these nations to adopt pro-growth budget, tax, and monetary policies, but clearly we're going to have to do more to restore Asian growth. We must work to lift the weight of private sector debt that has frozen the Asian economies.

Today, I'm asking Secretary Rubin to work with other financial authorities and international economic institutions to enhance efforts to explore comprehensive plans to help Asian corporations emerge from massive debt where individual firms have been swept under by systemic, national economic problems, rather than their own errors. We need to get credit flowing again. We need to get business back to making products, producing services, creating jobs.

Third, Asian businesses need assistance, but so do millions of Asian families. We must do more to establish an adequate social safety net in recovering nations. Wrenching economic transition without an adequate social safety net can sacrifice lives in the name of economic theory, and, I might add, can generate thereby so much resistance that reform grinds to a halt. If we want these countries to do tough things, we have to protect the most defenseless people in the society and we have to protect people who get hurt when they didn't do anything wrong. I think that is terribly important.

With our support, the World Bank and the Asian

Development Bank have started to deal with these challenges, but they have to expand their efforts. There is simply not enough being done. I asked them to double their aid through an expanded social compact initiative focusing on job assistance, basic needs and economic transition, on children and the elderly, on groups most vulnerable to economic change. And I want to commend Jim Wolfensohn for his efforts and his willingness to lead this expanded initiative. We have to be ready to respond immediately with financial force if necessary, to the currency crisis, if it spreads, especially if it threatens the economies of Latin America, where nations have struggled to make progress to do the right thing, only to find themselves buffeted by economic storms outside their control.

Therefore, the major economies should stand ready to activate the \$15 billion now in the emergency funds of the IMF, the general agreement to borrow, to ensure that the IMF continues to support reform and fight economic contagion.

Fifth, our Export-Import Bank will increase its commitments to specific economic development projects over the

next three years -- three months -- projects which will have concrete benefits for ordinary citizens in other countries, projects which will increase our own exports and thereby help our economy, and ones which can help to restore confidence in countries that they are not alone and that actual, specific, positive developments can occur.

Sixth, for the effort of the international community to succeed, America simply must meet its own obligations to the International Monetary Fund. After a year of financial firefighting, the IMF's resources are badly strained. Every day we don't act, we undermine the confidence the world badly needs that we are trying to restore. Congress simply must assume its responsibility for our leadership in the economy.

In my State of the Union address, I said it was better to prepare for a storm when the skies were clear than when the clouds were overhead. Well, eight months later, the clouds are closer, and you can nearly hear the thunder. Now, the Senate, by an overwhelming bipartisan majority, has, thankfully, approved our obligation to fund our part of the International Monetary Fund. But with only five weeks left in this congressional session, there is still no action from the House of Representatives.

Let me put this as plainly as I can: failure by this Congress to pay our dues to the IMF will put our own prosperity at risk. Failure to act will send a sharp signal that at a time of economic challenge, our lawmakers were unwilling to protect our workers, our businesses, our farmers from the risks of global economic change, and unwilling to maintain our leadership in building a global economy system that has benefited us more than any other nation.

Concerted action to spur growth, helping Asia through private sector debt restructuring, and a strengthened social safety net, helping to protect the rest of the world through the use of the IMF's emergency fund, increasing the activity of the Ex-Im Bank, and meeting our own obligations to the IMF -- these are the six immediate steps we want to take.

But we must also be willing to take action for the long run -- to modify the financial and trading institutions of the world to match the realities of the new economy they serve. By creating the WTO, the World Trading Organization, in 1994, we began to build a modern trading system. We must redouble our efforts to tear down barriers around the world. But as I said in Geneva last May, we must do more to ensure that spirited economic competition among nations never becomes a race to the bottom -- in environmental protection, consumer protection, or labor

standards.

We are working to open the procedures of the WTO to participation by the public and the full range of affected interests, so that people will know and see and be able to do for themselves things which will ensure that the trading system makes the world better for all the people in all the countries.

We've already completed 260 trade agreements, opening markets in areas from autos to telecommunications. Next year we will host the meeting of the world's trade ministers to set the agenda for expanded trade in the first decade in the new century.

History teaches us that at a time of worldwide difficulty, it would be folly to retreat into a protectionist shell. We must keep trade flowing among nations, but I will say again, if we want to do that, we have got to give ordinary citizens and the groups that represent them in countries all over the world the sense that it is going to be done in a fair way, consistent with nations' obligations to advance the interests of their working people and protect not only their national, but the global environment.

This November, when I meet with the leaders of the Asian economies at the APEC meeting, we will move forward to further open markets in Asia. And when Congress returns next year, I will work to pass legislation to open markets further --from trade negotiating powers to the African Trade Initiative. I will do so in a way that I believe will win broad support from a majority of both parties.

From the G-7 meeting in Halifax in 1995 in the wake of the Mexican financial crisis, to the Birmingham meeting this year, we have been working, also, with our major economic partners to plan for new financial architecture for the 21st century.

For the first time, this year we included key emerging markets in the process in a new Group of 22, recognizing their important stake in the global economy. This group has been working together for nearly a year now to improve the global financial assistance with a special focus on improving financial sectors, on transparency, and on private sector burden sharing.

I just want to emphasize again that even as we respond to the urgent alarms of the moment, we must speed the pace of this systemic work as well. That is why I have asked Secretary Rubin and Chairman Greenspan to convene the finance ministers and central bankers of the G-7 and key emerging economies in Washington within 30 days to develop a preliminary report to the heads of state by the beginning of next year on strengthening the world financial system.

We must develop policies so that countries can reap the benefits of free-flowing capital in a way that is safe and

sustainable. We must adapt the IMF so that it can more effectively confront the new types of financial crises, minimizing their frequency, severity, and human cost. We need to consider ways to extend emergency financing when countries are battling crises of confidence due to world financial distress as distinct from their own errors in policy. We must find ways to tap the energy of global markets without sentencing the world to a cycle of continued extreme crises.

For half a century now in our national economy, we have learned not to eliminate but to tame and limit the swings of boom and bust. In the 21st century, we have to find a way to do that in the global economy as well.

I've discussed this in recent days with Prime

Minister Blair of Great Britain, who is now the Chair of the G-7. He shares my belief that this is an urgent task. It is critical to the mission that he and I and Prime Minister Prodi of Italy will be discussing next week at the New York University Law School in a very interesting meeting that the First Lady and others in our administration helped to organize on how to extend

the benefits of the world economy to all and how to strengthen democracy in a time of such sweeping economic change.

Now, let me just say it all again very briefly: in short, we must improve our ability to address the current financial emergency, and we must build a system to prevent such future emergencies, whenever possible, and to blunt their impact when they do occur. There is no mission more critical to our own strength and security.

And let me say this again, what is at stake is more than the spread of free markets and their integration into the global economy. The forces behind the global economy are also those that deepen democratic liberties: the free flow of ideas and information, open borders and easy travel, the rule of law, fair and even-handed enforcement, protection for consumers, a skilled and educated work force.

Each of these things matters not only to the wealth of nations but to the health of freedom. If citizens tire of waiting for democracy and free markets to deliver a better life for them, there is a real risk that democracy and free markets, instead of continuing to thrive together, will begin to shrivel together. This would pose great risks not only for our economic interests but for our security.

We see around the world the international aggressors, the harborers of terrorists, the drug lords. Who are these countries? They're authoritarian nations without democracy

and without open markets. Nations that give their people freedom are good neighbors; when nations turn away from freedom, they turn inward toward tension, hatred, and hostility.

We now have a chance to create opportunity on a worldwide scale. The difficulties of the moment should not obscure us to the advances of the last several years. We clearly have it within our means, if we do the right things, to lift billions and billions of people around the world into a global middle class and into participation in global democracy and genuine efforts toward peace and reconciliation. That is a possibility, but recent events show it is not a certainty.

At this moment, therefore, the United States is called upon once again to lead -- to organize the forces of a committed world; to channel the unruly energies of the global economy into positive avenues; to advance our interests, reinforce our values, enhance our security.

In this room, I think it is not too simple to say we know what to do. The World War II generation did it for us 50 years ago. Now, it is time for us to rise to our responsibility, as America has called upon to do so often so many times in the past. We can, if we do that, redeem the promise of the global economy and strengthen our own nation for a new century.

Thank you very much. (Applause.)

END

12:34 P.M. EDT

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For Immediate Release  
1998

September 14,

REMARKS BY THE PRESIDENT  
TO THE COUNCIL ON FOREIGN RELATIONS

Council on Foreign Relations Building  
New York, New York

12:00 P.M. EDT

THE PRESIDENT: Thank you very much, Pete. Hillary and I are delighted to be here with you and Joan, and I'm glad to be joined by Secretary Rubin and Jim Harmon, Gene Sperling, other members of our team. I'm glad to see Dick Holbrooke over here. I hope, if we can overcome the inertia of Congress, he will soon be a member of the team again. (Applause.) And I thank David Rockefeller and Les Gelb and others who welcomed us here today.

The subject that I want to discuss -- let me just say one thing in advance -- I'm going to give you my best thoughts. We have been working on this for three years at some level of intensity or another, going back to the Naples G-7 meeting in the aftermath of the Mexican financial crisis. I have done everything I could do personally to reach out across the country, and indeed across the world, for any new ideas from any source. I'm going to give you my best thinking today about what we can do, but I want you to know that I'm here, and if I had my druthers, this would be about a three-hour session where I'd give this talk and then I would listen for the rest of the time.

So I want to encourage you, if you think we're right, to support us. But if you have any ideas, for goodness sake, share them, because I agree with what Pete said: this is the biggest financial challenge facing the world in a half-century. And the United States has an absolutely inescapable obligation to lead, and to lead in a way that's consistent with our values and our obligation to see that what we're doing helps lift the lives of ordinary people here at home and all around the world.

The Council on Foreign Relations has always stood for political and economic freedom, since right after World War I. And I think

one of the things that has impacted all of us, and it was implicit in what Pete said, is that for the last decade the growth of freedom around the world, with more than half the people in the world living under governments of their own choosing, more than half the villages, the one million villages in China now, even electing their own governments, and this sweeping replacement of command and control economies by market economies. I think it seems to have happened so easily, so effortlessly, so inexorably, that I think we think the trend is inevitable and irreversible.

But if you consider today's economic difficulties, disruptions, and the plain old, deep, personal disappointments of now tens of millions of people around the world, it is clear to me that there is now a stark challenge not only to economic freedom, but, if unaddressed, a challenge that could stem the rising tide of political liberty as well.

Obviously we have profound interests here. It is a great irony that we are at a moment of unsurpassed economic strength at a time of such turmoil in the world economy. We, I think all of us in this room, know that our future prosperity depends upon whether we can work with others to restore

confidence, manage change, stabilize the financial system, and spur robust global growth.

For most of the last 30 years, the United States and the rest of the world has been preoccupied by inflation, for reasons that all of you here know all too well -- and it was a good thing to be preoccupied with. Today the low and stable inflation we enjoy has been critical to our economic health, and low inflation has also contributed to that of many other nations as well. But clearly the balance of risks has now shifted, with a full quarter of the world's population living in countries with declining economic growth or negative economic growth.

Therefore, I believe the industrial world's chief priority today, plainly, is to spur growth. It seems to me there are six immediate steps we should take to help contain the current financial turmoil around the world, and then two longer-term projects in which we must be involved.

To take the immediate first, we must work with Japan, Europe, and other nations to spur growth. Second, we will expand our efforts to enable viable businesses in Asia to emerge from crippling debt burdens so they can once again contribute to

growth and job creation. Third, we've asked the World Bank to double its support for the social safety net in Asia to help people who are innocent victims of financial turmoil. Fourth, we'll urge the major industrial economies to stand ready to use the \$15 billion in IMF emergency funds to help stop the financial contagion from spreading to Latin America and elsewhere. Fifth, our Ex-Im Bank, under the leadership of Jim Harmon, will intensify its efforts to generate economic activity in the developing world immediately, in the next three months. And sixth, Congress must live up to its responsibility for continued prosperity by meeting our obligations to the International Monetary Fund.

Secretary Rubin has been working with his counterparts in the G-7 to get cooperative support for several of these measures. I understand Chairman Greenspan is also consulting with his counterparts on these items as well.

As we take these immediate steps, we also must intensify our efforts to reform our trade and financial institutions so that they can respond better to the challenges we now face and those we are likely to face in the future. We must build a stronger and more accountable global trading system, pressing forward with market-opening initiatives, but also advancing the protection of labor and environmental interests, and doing more to ensure that trade helps the lives of ordinary citizens across the globe.

Above all, we must accelerate our efforts to reform the international financial system. Today I have asked Secretary Rubin and Federal Reserve Board Chairman Greenspan to convene a major meeting of their counterparts within the next 30 days to recommend ways to adapt the international financial architecture to the 21st century.

Over the past six years, our strategy at home of fiscal discipline, investment in the skills of our people, and open trade has worked for all Americans. Unemployment at a 28-year low, inflation a 32-year low, wages rising at twice the rate of inflation after decades of stagnation. And on October 1st we'll have the first balanced budget in 29 years.

But the global economy brought a lot of that prosperity to us, and now fast-moving currents have brought or aggravated problems in Russia and Asia. They threaten emerging economies from Latin America to South Africa. With a quarter of the world's population in declining growth, we must recognize what Chairman Greenspan said the other day: we cannot forever be

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an oasis of prosperity. Growth at home depends upon growth abroad. A full 30 percent of our growth, just since I became President, has been due to our expanding positive involvement in the global economy.

That's why ordinary Americans should care if Asia or Russia or South America is on solid economic footing. These people are our customers. With one-third of the growth of our economy coming from exports, much of it from emerging markets, we know that those markets will falter as their economies flatten. When the problem is widespread and perceived to be moving in the wrong direction, we have seen that our stock market can react, having a direct and immediate impact on the wealth of the American people.

These nations are also our competitors. And under conditions of decent equilibrium that is a very good thing, indeed. But when their currencies drop precipitously, the prices of their goods fall, they could undercut the sales of our own goods here at home that are otherwise profitable, dramatically increasing our trade deficit under circumstances that could cause the American people to turn away from open trade toward protectionism in a way that has terrific negative consequences long-term for our global growth objectives.

Finally, these nations are our friends, our allies and our security partners. Where economic turmoil plunges millions into sudden poverty and disrupts and disorients the lives of ordinary people, the risks of political and social instability and of a turn from democracy clearly rise. Just look at Russia. Russia is facing an economic crisis that threatens the extraordinary progress the Russian people have made in just seven years, building a new society from the ground up. The ruble and the stock market have plummeted, banks are weak, tax collections have slowed, the government has trouble paying its debts and its salaries.

Some Russians have become wealthy, but many, many more are struggling to provide for their families. I talked to some of them when I was in Russia just a few days ago.

Amid such political uncertainty and economic difficulty, some now talk of abandoning the path of reform and returning to policies of the past, even policies that have already failed. At worst, adversity in Russia could affect not only the Russian economy and prospects for our economic cooperation -- at worst, it could have an impact on our cooperation with Russia on nuclear disarmament, on fighting terrorism and the spread of weapons of mass destruction, on standing together for peace, from the Balkans to the Middle East.

Now Russia has a new Prime Minister, Mr. Primakov, who's been in office a grand total of four days. He and President Yeltsin face one of the great challenges of their time. Never has there been a more important moment to set a clear direction for the future, to affirm the commitment of Russia to democracy and to free markets, and to take decisive steps to stabilize the economy and restore investor confidence.

But if Russia is willing to take these steps, we must do everything we can to provide support to them. Because again I say, as long as ordinary people don't feel any benefits from this, in the end it's going to be difficult to sustain the direction we think the world should take.

On the other hand, we need to be honest with Russia and everyone else. No nation, rich or poor, democratic or authoritarian, can escape the fundamental economic imperatives of the global market. No nation can escape its discipline. No nation can avoid its responsibility to do its part.

But since all economies are increasingly interdependent, fear and uncertainty about the economy of one country can prompt investors to pull money out of other countries thousands of miles away. Markets work best when they are driven neither by excessive inflows or outflows of capital based on indiscriminate optimism or pessimism.

Regardless of what changes in policies or institutions may be warranted, we have to say we'll only be able to help those countries who are willing to help themselves. If a nation chooses to print money indiscriminately, to wink at cronyism or corruption, to hide bad loans and protect corrupt or inefficient banks, then investors, foreign and domestic, sooner or later, will withdraw their investments, with consequences both swift and severe.

That is why we support the fundamental approach of the International Monetary Fund to extend assistance only when nations have taken responsibility, strengthening their banking systems, introducing honest accounting and open markets, awarding credit on merit instead of connections.

Still, what has been done is clearly not enough to reverse the decline in particular countries, to douse the flames of the international financial crisis, to support steady and sustainable growth in the future. In the face of this new challenge, America can and must continue to act and to lead to take the urgent steps needed today to calm the financial crisis, restart the engine of growth in Asia, and minimize the impact of financial turmoil on other nations, and to make certain that for tomorrow the institutions and rules of international finance and international trade are prepared to support steady and sustainable growth over the long term.

First and foremost, the leading economic nations must act together to spur global growth. Our strong and growing economy here has made a major contribution to global growth, just as our weak economy was holding the world back six years ago when I attended my first G-7 meeting in Tokyo and every other country



said, the first thing they needed was for America to put its economic house in order. We did that.

Now I believe strongly we must maintain our fiscal discipline. It has led to lower interest rates and a huge investment and job growth. Maintaining economic growth is the best thing we can do right now, not only for the United States but for the global economy.

I would also remember that back in 1993 we had a general agreement that what was needed was America should get rid of its deficit, Europe should lower its interest rates, and Japan should open its markets. There was this general agreement that if we did all those things, we would have a remarkable resumption of growth.

Europe did moderate its interest rates and the then prime minister -- now the finance minister -- Mr. Miyazawa, oversaw a significant market opening trade agreement between the United States and Japan, which also benefited others, not just us. And of course we got rid of our deficit. The results were quite satisfactory for several years for us.

Now Europe has to continue to pursue policies that will spur growth and keep their markets open because they, too, must be able to provide markets for Asian goods as those nations seek to find their footing. But the key here is Japan, for the second largest economy in the world, by far the biggest economy in Asia, has now gone several years without any economic growth. Thank goodness, a lot of their ordinary citizens have been able to maintain a decent life because of the wealth of their country and probably because of the enormous personal savings rate they

have enjoyed for many, many years now.

But it is difficult to see how any actions of the world community can be successful in restoring growth in Asia in the absence of the restoration of growth in Japan, which would enable Japan to lead the region out of its present condition. Therefore, we must support Japan and do everything we can to help create the conditions in which, together, we can all lead again, just as we did in 1993.

Their challenges are quite formidable. They have to spur domestic demand, revive a banking system, restore confidence, deregulate the economy, and open markets. And we all know all the forces that seem to be working against these developments in Japan. But I would remind you that this is a very strong, sophisticated nation full of people of knowledge and enormous achievement. It is fully capable of playing its world leadership role. I believe its business leaders right now know what needs to be done and would support it.

Next week I'm going to meet with Prime Minister Obuchi here in New York to discuss how America can support Japan's efforts to restore economic growth and investor confidence. And I will do everything I can to try to make sure that as we go forward, we have America, Europe, and Japan all doing our part to get beyond this present moment, just as we did back in 1993.

The second step we should take is to intensify our efforts to speed economic recovery in Asia. When countries like South Korea and Thailand have taken strong and responsible steps, the freefall has ended, progress is being made. But the human cost of Asia's collapse is only now being fully felt. Recent press reports have described an entire generation working its way into the middle class over 25 years, then being plummeted into poverty within a matter of months. The stories are heartbreaking -- doctors and nurses forced to live in the lobby of a closed hospital; middle class families who own their own homes, sent their children to college, traveled abroad, now living by selling their possessions.

It is in our interest to help these nations and these people recover. They will become once again our great markets and our great partners. It is also the right thing to do. We've worked with international lenders, like the IMF, to help these nations to adopt pro-growth budget, tax, and monetary policies, but clearly we're going to have to do more to restore Asian growth. We must work to lift the weight of private sector debt that has frozen the Asian economies.

Today, I'm asking Secretary Rubin to work with other financial authorities and international economic institutions to enhance efforts to explore comprehensive plans to help Asian corporations emerge from massive debt where individual firms have been swept under by systemic, national economic problems, rather than their own errors. We need to get credit flowing again. We need to get business back to making products, producing services, creating jobs.

Third, Asian businesses need assistance, but so do millions of Asian families. We must do more to establish an adequate social safety net in recovering nations. Wrenching economic transition without an adequate social safety net can sacrifice lives in the name of economic theory, and, I might add, can generate thereby so much resistance that reform grinds to a halt. If we want these countries to do tough things, we have to protect the most defenseless people in the society and we have to protect people who get hurt when they didn't do anything wrong. I think that is terribly important.

With our support, the World Bank and the Asian

Development Bank have started to deal with these challenges, but

they have to expand their efforts. There is simply not enough being done. I asked them to double their aid through an expanded social compact initiative focusing on job assistance, basic needs and economic transition, on children and the elderly, on groups most vulnerable to economic change. And I want to commend Jim Wolfensohn for his efforts and his willingness to lead this expanded initiative. We have to be ready to respond immediately with financial force if necessary, to the currency crisis, if it spreads, especially if it threatens the economies of Latin America, where nations have struggled to make progress to do the right thing, only to find themselves buffeted by economic storms outside their control.

Therefore, the major economies should stand ready to activate the \$15 billion now in the emergency funds of the IMF, the general agreement to borrow, to ensure that the IMF continues to support reform and fight economic contagion.

Fifth, our Export-Import Bank will increase its commitments to specific economic development projects over the next three years -- three months -- projects which will have concrete benefits for ordinary citizens in other countries, projects which will increase our own exports and thereby help our economy, and ones which can help to restore confidence in countries that they are not alone and that actual, specific, positive developments can occur.

Sixth, for the effort of the international community to succeed, America simply must meet its own obligations to the International Monetary Fund. After a year of financial firefighting, the IMF's resources are badly strained. Every day we don't act, we undermine the confidence the world badly needs that we are trying to restore. Congress simply must assume its responsibility for our leadership in the economy.

In my State of the Union address, I said it was better to prepare for a storm when the skies were clear than when the clouds were overhead. Well, eight months later, the clouds are closer, and you can nearly hear the thunder. Now, the Senate, by an overwhelming bipartisan majority, has, thankfully, approved our obligation to fund our part of the International Monetary Fund. But with only five weeks left in this congressional session, there is still no action from the House of Representatives.

Let me put this as plainly as I can: failure by this Congress to pay our dues to the IMF will put our own prosperity at risk. Failure to act will send a sharp signal that at a time of economic challenge, our lawmakers were unwilling to protect our workers, our businesses, our farmers from the risks of global economic change, and unwilling to maintain our leadership in building a global economy system that has benefited us more than any other nation.

Concerted action to spur growth, helping Asia through private sector debt restructuring, and a strengthened social safety net, helping to protect the rest of the world through the use of the IMF's emergency fund, increasing the activity of the Ex-Im Bank, and meeting our own obligations to the IMF -- these are the six immediate steps we want to take.

But we must also be willing to take action for the long run -- to modify the financial and trading institutions of the world to match the realities of the new economy they serve. By creating the WTO, the World Trading Organization, in 1994, we began to build a modern trading system. We must redouble our efforts to tear down barriers around the world. But as I said in Geneva last May, we must do more to ensure that spirited economic competition among nations never becomes a race to the bottom -- in environmental protection, consumer protection, or labor

standards.

We are working to open the procedures of the WTO to participation by the public and the full range of affected interests, so that people will know and see and be able to do for themselves things which will ensure that the trading system makes the world better for all the people in all the countries.

We've already completed 260 trade agreements, opening markets in areas from autos to telecommunications. Next year we will host the meeting of the world's trade ministers to set the agenda for expanded trade in the first decade in the new century.

History teaches us that at a time of worldwide difficulty, it would be folly to retreat into a protectionist shell. We must keep trade flowing among nations, but I will say again, if we want to do that, we have got to give ordinary citizens and the groups that represent them in countries all over the world the sense that it is going to be done in a fair way, consistent with nations' obligations to advance the interests of their working people and protect not only their national, but the global environment.

This November, when I meet with the leaders of the Asian economies at the APEC meeting, we will move forward to further open markets in Asia. And when Congress returns next year, I will work to pass legislation to open markets further --from trade negotiating powers to the African Trade Initiative. I will do so in a way that I believe will win broad support from a majority of both parties.

From the G-7 meeting in Halifax in 1995 in the wake of the Mexican financial crisis, to the Birmingham meeting this year, we have been working, also, with our major economic partners to plan for new financial architecture for the 21st

century.

For the first time, this year we included key emerging markets in the process in a new Group of 22, recognizing their important stake in the global economy. This group has been working together for nearly a year now to improve the global financial assistance with a special focus on improving financial sectors, on transparency, and on private sector burden sharing.

I just want to emphasize again that even as we respond to the urgent alarms of the moment, we must speed the pace of this systemic work as well. That is why I have asked Secretary Rubin and Chairman Greenspan to convene the finance ministers and central bankers of the G-7 and key emerging economies in Washington within 30 days to develop a preliminary report to the heads of state by the beginning of next year on strengthening the world financial system.

We must develop policies so that countries can reap the benefits of free-flowing capital in a way that is safe and sustainable. We must adapt the IMF so that it can more effectively confront the new types of financial crises, minimizing their frequency, severity, and human cost. We need to consider ways to extend emergency financing when countries are battling crises of confidence due to world financial distress as distinct from their own errors in policy. We must find ways to tap the energy of global markets without sentencing the world to a cycle of continued extreme crises.

For half a century now in our national economy, we have learned not to eliminate but to tame and limit the swings of boom and bust. In the 21st century, we have to find a way to do that in the global economy as well.

I've discussed this in recent days with Prime

Minister Blair of Great Britain, who is now the Chair of the G-7. He shares my belief that this is an urgent task. It is critical to the mission that he and I and Prime Minister Prodi of Italy will be discussing next week at the New York University Law School in a very interesting meeting that the First Lady and others in our administration helped to organize on how to extend

the benefits of the world economy to all and how to strengthen democracy in a time of such sweeping economic change.

Now, let me just say it all again very briefly: in short, we must improve our ability to address the current financial emergency, and we must build a system to prevent such future emergencies, whenever possible, and to blunt their impact when they do occur. There is no mission more critical to our own strength and security.



And let me say this again, what is at stake is more than the spread of free markets and their integration into the global economy. The forces behind the global economy are also those that deepen democratic liberties: the free flow of ideas and information, open borders and easy travel, the rule of law, fair and even-handed enforcement, protection for consumers, a skilled and educated work force.

Each of these things matters not only to the wealth of nations but to the health of freedom. If citizens tire of waiting for democracy and free markets to deliver a better life for them, there is a real risk that democracy and free markets, instead of continuing to thrive together, will begin to shrivel together. This would pose great risks not only for our economic interests but for our security.

We see around the world the international aggressors, the harborers of terrorists, the drug lords. Who are these countries? They're authoritarian nations without democracy and without open markets. Nations that give their people freedom are good neighbors; when nations turn away from freedom, they turn inward toward tension, hatred, and hostility.

We now have a chance to create opportunity on a worldwide scale. The difficulties of the moment should not obscure us to the advances of the last several years. We clearly have it within our means, if we do the right things, to lift billions and billions of people around the world into a global middle class and into participation in global democracy and genuine efforts toward peace and reconciliation. That is a possibility, but recent events show it is not a certainty.

At this moment, therefore, the United States is called upon once again to lead -- to organize the forces of a committed world; to channel the unruly energies of the global economy into positive avenues; to advance our interests, reinforce our values, enhance our security.

In this room, I think it is not too simple to say we know what to do. The World War II generation did it for us 50 years ago. Now, it is time for us to rise to our responsibility, as America has called upon to do so often so many times in the past. We can, if we do that, redeem the promise of the global economy and strengthen our own nation for a new century.

Thank you very much. (Applause.)

END

12:34 P.M. EDT

To:

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Lori E. Abrams  
Jeannetta P. Allen  
Lori L. Anderson  
Brenda M. Anders  
Eli G. Attie @ OVP@EOP  
Patrick Aylward  
Robin J. Bachman  
Kyle M. Baker  
Karen L. Barbuschak  
Beverly J. Barnes  
Brian A. Barreto  
Mark H. Bartholomew  
David S. Beaubaire  
Paul E. Begala  
Mark J. Bernstein  
Marsha E. Berry  
antony j. blinken  
Alexander L. Boyle  
Lanny A. Breuer  
Patrick E. Briggs  
Erin L. Brinkman  
Katharine Button  
Robin J. Bachman  
Barbara D. Woolley  
Bradley M. Campbell  
Alejandro G. Cabrera @ ovp@eop  
Dominique L. Cano  
Laura Capps  
Elizabeth A. Castellani  
Joseph W. Cerrell @ OVP@EOP  
David K. Chai  
Andrei H. Cherny @ ovp@eop  
Nanda Chitre  
Delia A. Cohen  
Julianne B. Corbett  
Michelle Crisci  
Lisa R. Dass  
Elliot J. Diringer  
Daniel W. Burkhardt  
Diane Ikemiyashiro  
Dorian V. Weaver  
Dorinda A. Salcido  
Douglas Matties  
Anne M. Edwards  
Rahm Emanuel  
Patricia M. Ewing @ OVP@EOP  
Joseph C. Fanaroff  
Jennifer Ferguson  
Julie A. Fernandes  
Martha Foley  
Carmen B. Fowler  
Grace A. Garcia  
KARA GERHARDT

Jessica L. Gibson  
Adam W. Goldberg  
Dario J. Gomez  
David R. Goodfriend  
Peter D. Greenberger  
John A. Gribben  
Donald Goldberg  
Lawrence J. Haas @ OVP@EOP  
William C. Haymes  
Maureen A. Hudson  
Sheyda Jahanbani  
Sheyda Jahanbani  
Thomas D. Janenda  
david t. johnson  
Wayne C. Johnson  
Michele Jolin  
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Jon P. Jennings  
Julie E. Mason  
David E. Kalbaugh  
Jonathan A. Kaplan  
Mark A. Kitchens  
Catherine T. Kitchen  
Sarah S. Freeman  
Jim Kohlenberger @ OVP@EOP  
Kris M Balderston  
Sara M. Latham  
Christopher J. Lavery  
Christopher S. Lehane @ OVP@EOP  
Joseph P. Lockhart  
Laura D. Schwartz  
Laura K. Capps  
Lisa J. Levin  
Christine N. Macy  
michael d. malone  
Laura S. Marcus  
Tanya E. Martin  
Doris O. Matsui  
Douglas R. Matties  
Emory L. Mayfield  
Andrew J. Mayock  
Anne E. McGuire  
Estela Mendoza  
Noa A. Meyer  
R. Scott Michaud  
Elisa Millsap  
Cheryl D. Mills  
Rajiv Y. Mody  
megan moloney  
Kevin Moran  
Melissa M. Murray  
Reuben L. Musgrave Jr.  
Mindy E. Myers  
Sean P. Maloney

Sandra L. Tijerina  
Amy W. Tobe  
Barry J. Toiv  
Serena C. Torrey  
Karen Tramontano  
June G. Turner  
Thurgood Marshall Jr  
Dag Vega  
Virginia Apuzzo  
Michael Waldman  
Angelina Walker @ ovp@eop  
Essence P. Washington  
Glen M. Weiner  
Robert S. Weiner  
Peter A. Weissman  
Lowell A. Weiss  
Woyneab M. Wondwossen  
Debra S. Wood  
William H. White Jr.  
SUNTUM\_M @ A1@CD@LNGTWY  
SUNTUM\_M @ A1@CD@LNGTWY  
meglynn @ usia.gov@INET@LNGTWY  
tingen-terrie @ dol.gov@INET@LNGTWY  
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CUTLER\_L @ A1@CD@LNGTWY  
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skgmd @ umich.edu@INET@LNGTWY  
tingen-terri @ dol.gov@INET@LNGTWY  
usia01 @ access.digex.com@INET@LNGTWY  
1=US@2=WESTERN UNION@3=@5=ATT.COM@\*ELN\62955104@MRX@LNGTWY  
62955104 @ eln.attmail.com@INET@LNGTWY  
INFOMGT @ A1@CD@LNGTWY  
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Releases @ pub.pub.whitehouse.gov@INET@LNGTWY

Michael V. Terrell  
Steven J. Naplan  
Mark D. Neschis  
Elizabeth R. Newman  
Nathan B. Naylor @ ovp@eop  
Neera Tanden  
Jonathan Orszag  
Eleanor S. Parker  
Carole A. Parmelee  
Sally P. Paxton  
Julia M. Payne  
Matthew W. Pitcher  
Phillip Caplan  
Nicole R. Rabner  
Brian A. Reich @ OVP@EOP  
Linda Ricci  
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Charles F. Ruff  
Peter Rundlet  
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