20

HIGH INTEREST RATES

AND BAD LOANS FROM ECONOMIC CRISIS UNDER DEFECTIVE CURRENCY LIBERALIZATION

HIGH INTEREST RATES:

THE EVIL IMPACT OF CURRENCY LIBERALIZATION WITHOUT SAFETY NET THAT PRODUCED THE EXPORT-IMPORT OF ECONOMIC PROBLEMS AMONG NATIONS

IMF could have totally or substantially avoided prescribing ultra high interest rates in the 1997-1998 Asian meltdown had it been proactive rather than reactive in the attainment of its mission. As a prime mover of currency liberalization under globalization, IMF helped promote the free flow of advanced nations' massive investment funds to developing Asian countries. The foreign fund inflow fueled the phenomenal growth of affected Asian economies before the crisis. However, as the funds were in effect direct and indirect lending to the developing nations, in the long run, there was a probability that future collections may be marred by delinquencies and bad loans, especially if there were economic aberrations. Thus, as part of IMF's risk management, it should have instituted safety nets to currency liberalization, like exchange rate hedging on foreign loans granted to dollar-debt-ridden Asian corporations.

When IMF did nothing and the Asian crisis erupted, it faced an onrushing tsunami of exchange losses among dollar-debt-ridden Asian companies. The losses could translate to bad loans in the origins of the huge investment funds that flowed into the region—the advanced nations that control IMF. To address the problem, IMF sacrificed Asian banks and borrowers through subsidy-laden, anti-market, and disastrous but superfluous—in other words, technically wrong—high-interest-rate cure. It spawned humongous bad loans in scourged Asian economies. Yet, most economists do not mind it, let alone write against it. They do not see it as a problem in the first place; they consider it an economic wisdom! ***Notable exceptions, though, were three Nobel laureates in economics who saw high interest rates as inappropriate in the Asian crisis. They were Merton Miller,[i] Joseph Stiglitz,[ii] and Robert Mundell.[iii]***

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[i] "Asia wrong to raise interest vs speculation," *Manila Bulletin*, January 20, 1980.

[ii] Harry Dunphy, "WB says world economy still faces risk of recession," *Manila Bulletin,* December 4, 1998, p. B-8).

[iii] "IMF has lost credibility, says Nobel prize-winning economist," *Philippine Daily Inquirer*, July 10, 2001, p. B7.

PART I
THE ECONOMIC WISDOM OF HIGH INTEREST RATES AND ITS MISAPPLICATION IN THE ASIAN CRISIS

The conventional high-interest-rate economic wisdom is normally employed by monetary authorities to attain the chain objectives of minimized borrowing, tightened money supply, discouraged currency speculation, stabilized exchange rate, curbed currency depreciation, and ultimately contained inflation.[iv]

As part of globalization, WTO, World Bank, and IMF promoted currency liberalization that enabled the free flow of dollars to Asian economies. As safety net against exchange losses from unpredictable economic aberration, IMF should have prescribed exchange rate hedging to dollar-recipient Asian economies, but it did not. When the Asian crisis erupted in Thailand in mid-1997, with contagion effect in four other Asian countries including the Philippines, foreign fund managers had to repatriate their funds to safe havens. In the absence of exchange rate hedging due to IMF oversight, to stave off capital flight that would result in huge exchange losses to dollar-debt ridden Asian corporations, with concomitant bad loans to their foreign creditors in the US and other nations that control IMF, IMF officials had to prescribe catastrophic 60% high loan rate to crisis-stricken Asian economies.

IMF'S AND CENTRAL BANK'S RATIONALE FOR HIGH INTEREST RATES IN THE ASIAN CRISIS

1. High Interest Rates as Antidote to Currency Speculation and Capital Flight

As quoted on pages 17 to 18 of the book *Puzzlers: Economic Sting,* the highest IMF officials rationalized their prescribed high interest rates in the Asian turmoil as follows:

a. From then IMF First Deputy Managing Director, Stanley Fischer (Stanley Fischer, "The IMF and the Asian Crisis," Forum Funds Lecture at UCLA, Los Angeles on March 20, 1998):

[iv] Marcelo L. Tecson, Sr., *Puzzlers: Economic Sting* (Makati City, Philippines: Raiders of the Lost Gold Publication, 2005), p. 104.

When their governments "approached the IMF, the reserves of Thailand and Korea were perilously low, and the Indonesian Rupiah was excessively depreciated. Thus, the first order of business was...to restore confidence in the currency. To achieve this, countries have to make it more attractive to hold domestic currency, which in turn, requires increasing interest rates temporarily, even if higher interest costs complicate the situation of weak banks and corporations.... Why not operate with lower interest rates and a greater devaluation? This is a relevant tradeoff, but there can be no question that the degree of devaluation in the Asian countries is excessive, both from the viewpoint of the individual countries, and from the viewpoint of the international system. Looking first to the individual country, companies with substantial foreign currency debts, as so many companies in these countries have, stood to suffer far more from... currency (depreciation) than from a temporary rise in domestic interest rates.... Thus on macroeconomics... monetary policy has to be kept tight to restore confidence in the currency...."

b. From the then IMF Managing Director Michel Camdessus himself ("Doctor Knows Best?" *Asiaweek*, July 17, 1998, p. 46):

"To reverse (currency depreciation), countries have to make it more attractive to hold domestic currency, and that means temporarily raising interest rates, even if this (hurts) weak banks and corporations."

2. High Interest Rates as Source of Payment for High Interest Income Designed to Discourage Dollar Speculation

With the onset of the crisis, Asian banks were caught in a liquidity squeeze by capital flight. Prudent fund managers were withdrawing their volatile foreign funds from the Asian economies, for repatriation to safe investment havens abroad. However, as the short-term foreign funds were locked in long-term local loans for infrastructure and real estate projects, the banks could not fully service the sudden bank withdrawals. With the capital flight that had been depreciating the Asian currencies, even Asian residents wanted to convert their Asian currencies to dollars to avoid ending up with depreciated local currencies. With the surge in dollar demand, withdrawals of Asian currencies for conversion to dollars would follow. With the banks in a liquidity squeeze, if they could not fully service the withdrawals, depositors would panic and there would be dreaded bank runs. Therefore, preventing the snowballing dollar demand was imperative.

To dampen dollar demand, central banks had to institute tight-money measures—like raising key policy interest rates and bank reserves—as a cue to banks to raise interest rates. The increase in lending rates would be used to pay a corresponding increase in interest income by bank depositors. The dramatic increase in interest income would encourage depositors to maintain high-yielding local currency deposits instead of buying dollars. With dollar speculation or hoarding discouraged, the banking system would calm down.

Sadly, while local banks raised lending rates up to about 40%, based on the July 27, 1998 BSP report, the expected surge in high-yielding deposits in lieu of capital flight and dollar speculation did **not** materialize. Worse, banks continued to pay the bulk of deposits—ordinary savings accounts—at 2% deposit rate despite their very high lending rates. This scheme made the real-interest-rate wisdom a sham. It was supposed to protect depositors from inflation through increase in their deposit rates, to be derived from increase in lending rates, but this idea never occurred to BSP and was not done.

HIGH-INTEREST-RATE FALLACIES: IMF'S 60% HIGH-INTEREST-RATE CURE HAS FATAL DEFECTS AND DOES NOT ATTAIN OBJECTIVE, HENCE IT SHOULD BE DISCARDED

1. HIGH INTEREST RATES PROVOKED MASSIVE LOAN DEFAULTS, BAD LOANS, AND BANKRUPTCIES OF INNOCENT BORROWERS

IMF-prescribed high interest rates provoked massive loan defaults and bad loans—the price that innocent borrowers and banks of crisis-hit Asian nations unwarrantedly paid for IMF's monumental negligence—committed before the Asian crisis—to prescribe exchange rate hedging on Asian corporations' foreign loans. IMF tried to make up for its negligence during the crisis by fallaciously prescribing high interest rates, aimed at preventing currency speculation, stabilizing exchange rates, and minimizing exchange losses of dollar-debt-laden Asian companies.

The back-breaking high interest rates massacred by way of unprecedented bad loans numerous innocent Filipino borrowers, some three million of them—including this writer who could not accept disastrous but useless high interest rates, hence he wrote a book on it, *Puzzlers: Economic Sting.* Contrary to IMF's and central banks' expectation, despite high interest rates, currencies of crisis-hit Asian nations depreciated just the same (p. 344).

From the then regional magazine *Asiaweek* and the Internet, **bad loans** were what ailed the banking systems of the crisis-stricken Asian nations due to IMF-prescribed high interest rates:

Indonesia: problem loans—75% of total loans as of 1999; required bank recapitalization—$90 billion (Don Roper, "Indebtedness and Turbulence in Indonesia," as posted to the Internet as of 2002).

Thailand: problem loans—42% of total as of November 1999; bad loans—$63 billion (Wayne Arnold, "Fewer Bad Loans in Thailand," *New York Times*, December 30, 1999, as posted to the Internet as of 2002).

South Korea: problem loans—30% of total by end 1999; required bank recapitalization—$50 billion ("How East Asia is tackling banking ills," *Asiaweek*, July 31, 1998 issue, p. 49).

Malaysia: problem loans—30% of total by early 2000; required bank recapitalization—$15 billion ("How East Asia is tackling banking ills," *Asiaweek*, July 31, 1998 issue, p. 49).

Philippines: problem loans—31% as of 2001 and 36% as of 2002; bad loans—$9 billion as of 2001 and $11 billion as of 2002 [Bangko Sentral ng Pilipinas website as of 2001; *Manila Bulletin,* October 24, 2002, p. 1; Marcelo L. Tecson, Sr., *Puzzlers: Economic Sting,* (Makati City, Philippines: Raiders of the Lost Gold Publication, 2005), pp. 59, 72].

Consequently, based on the 1998 IMF annual report as cited on the Internet, IMF had to arrange the following **bailout funds** for crisis-hit Asian countries that sought its financial assistance:

- South Korea: $58 billion
- Indonesia: $42 billion
- Thailand: $17 billion.

The Philippines did not ask for a bailout fund because it had a mere contagion crisis. In fact, it was about to exit from IMF tutelage before the crisis, which could have enabled BSP to resist IMF's high-interest-rate cure—but it did not.

2. THE HIGH-INTEREST-RATE CURE WAS A SUBSIDY SCHEME

Can't IMF See that it is Absurd to Have Wrong Parties—Borrowers—Sacrifice, to the Extent of their Bankruptcy, For Free-Lunching Dollar-Debt-Ridden Asian Companies that they Do Not Own in the First Place—from Which they Never Profited in the Past, and from Which they Will Never Profit in the Future?

In the past, when the going was great, dollar-debt-ridden Asian corporations benefited from their foreign loans. These helped them generate profits solely for their stockholders., who received the profits through cash and stock dividends. Then, when the Asian crisis struck and the going was tough, under free market the Asian corporations should suffer the consequences of their negligent act—risk mismanagement through failure to obtain exchange rate hedging on their foreign loans. However, this was not the case under IMF's violation of free market by way of its prescribed out-of-the-market high interest rates, charged by banks on a no-choice basis to victimized captive old-loan borrowers. Through high interest rates as monetary tool against currency speculation, consequent currency depreciation, and corollary exchange losses, IMF in effect unduly shifted the burden of saving these corporations from the right parties—owner-stockholders—to the wrong ones: Asian borrowers.

To begin with, the borrowers were totally unrelated to the corporations and never benefited from their foreign loans and past profits. Worse, borrowers had to save the corporations at the price of disasters to the borrowers themselves. Afterward, when the crisis is gone, the dollar-debt-ridden corporations saved by borrowers will generate profits again—but none of their profits will ever be used to help the now-bankrupt borrowers who saved them in the past. In short, in gross violation of sound economics, morals, fair play, logic, the benefit principle of taxation or public finance, and free-market non-intervention, ***IMF played God with the lives of unsuspecting Asian borrowers.*** It heaped all sacrifices upon discriminated borrowers and all profits upon favored dollar-debt-ridden corporations. What happened, pray tell, to the economic tenet that there is no such thing as free lunch, as well as IMF's distaste for subsidies?

3. HIGH INTEREST RATES IMPAIRED THE FINANCIAL CAPACITY OF BORROWERS, THE FOUNDATION OF STRENGTH OF THE BANKING SYSTEM

Anybody with enough common sense and financial savvy would not have done it. But IMF, the central bank of central banks, did it in the past crisis—protecting the central-bank-supervised banking system by fallaciously impairing, through high interest rates, the financial capacity of the source of its stability—the all-important borrowing sector.

VERY IMPORTANT: The paying ability of borrowers is the foundation of strength of the banking system. No amount of reforms in banks will work if borrowers cannot religiously repay their loans.

The reason is simple—the banking system's actual role is that of **intermediary** or conduit of funds between depositors and borrowers, not ultimate custodian of depositors' money. The depositors' deposits are not supposed to stay idle under the banks' possession but promptly lent out to borrowers. Consequently, at any given time, banks are merely holding empty bags because the bulk of deposits received is no longer with them. It is with the ***de facto*** **custodian** of depositors' money, the nation's borrowers, to whom banks have already entrusted the depositors' funds as approved and released loans. Part of the deposits is also with the central bank as required bank reserves. ***Thus, during the regional crisis, the bulk of depositors' deposits was in the possession or accountability of the borrowing sector as outstanding bank lending to it. Specifically, out of ₱1.5-trillion aggregate deposits in the Philippine commercial banking system during the Asian turbulence,*** [v] ***₱1.4 trillion was already in the custodianship and disposal of borrowers as bank loans.*** [vi] The remaining relatively small balance was held by banks as loanable funds and as cash for servicing depositors' withdrawals.

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[v] How the banks fared," *Philippine Daily Inquirer*, May 10, 1999, p. D4.

[vi] Patrisha Joan F. de Leon, "What will make banks lend anew?" *Business World*, August 26, 1999, p. 1.

Basically, IMF and central banks should protect the depositing public's money entrusted to the banking system. As the deposits are now with borrowers as bank loans, borrowers should be amply protected, otherwise, the banking industry holding empty bags cannot fully get back from borrowers the depositors' lent-out funds. So, borrowers have to be held inviolate and insulated from economic convulsion so that they can amortize their loans even during hard times. In defiance of this common-sense or rational wisdom, in the handling of economic crisis and protection of depositors' money, IMF and central banks committed the blunder of intentionally saddling borrowers with unbearable high interest rates that destroyed their capacity to repay their loans. Their financial incapacity boomeranged to banks as destabilizing bad loans.[vii]

4. THE IMF-PRESCRIBED ULTRA HIGH INTEREST RATE WAS FOUNDED ON THE UTTERLY WRONG PREMISE THAT THE MORE SEVERE THE CRISIS, THE MORE NEED FOR HIGHER INTEREST RATE; IT WAS WRONG BECAUSE THE REVERSE WAS TRUE—THE MORE SEVERE THE CRISIS, THE MORE THE BUSINESS SLUMP AND UNCERTAINTIES FRIGHTEN PEOPLE FROM BORROWING WITH OR WITHOUT HIGH INTEREST RATE. THEREFORE, IN THIS CASE, ULTRA HIGH INTEREST RATE AS POTENT TIGHT-MONEY POLICY TOOL WAS SUPERFLUOUS OR USELESS AND CONSTITUTES A CRIME AGAINST VICTIMIZED BORROWERS.

During economic crisis, the IMF-prescribed 60% ultra high interest rate—which arbitrarily and whimsically doubles borrowers' huge loan principal in less than two years—is a big hoax, fraud, farce, or out-and-out IMF error that massacres innocent corporate and individual borrowers, destabilizes banking systems, and scourges economies—all for nothing. Reason: IMF's ultra high-interest-rate cure is anchored on the monumentally erroneous premise that the need for high Interest rates is directly—rather than inversely—proportional to the severity of economic crisis. Therefore, despite the havoc that the solution wreaks in economies, it is useless in the attainment of objective—because other economic factors like business slump and uncertainties discourage borrowing and lending and tighten money supply even without high interest rate.

[vii] Marcelo L. Tecson, Sr., *Puzzlers: Economic Sting* (Makati City, Philippines: Raiders of the Lost Gold Publication, 2005), pp. vi, 59-60.

The extreme economic folly of IMF's 60% ultra high-interest-rate prescription springs from its implied premise that the need for high interest rates is directly proportional to the severity of the economic crisis, that is, the more severe the crisis, the more need for higher interest rates in tightening money supply, maintaining investor confidence, stopping capital flight, and so on—as in the case of the 65% ultra high interest rate in Indonesia when it went through a combined political-economic convulsion in 1998.

In reality, the reverse is true—the need for high interest rates, if at all, is inversely proportional to the intensity of the crisis. In a situation of ultra economic crisis, especially if attended to by political turbulence or threat of civil war, other economic factors—such as mass capital flight and a more pronounced slump in borrowing and lending—come into greater play and diminish much more the role of high interest rates as a tight-money policy tool, through automatically constricting more severely the existing money supply and rendering superfluous the tight-money-measure high interest rates.

The really serious economic turbulence can be characterized by combined political-economic upheaval, which could escalate to civil war and spawn riots, bloodshed, plunder, arson, burning of bank records evidencing foreign fund placements, ransacking of bank vaults, and total loss of foreign funds under the care of non-surviving banks and non-bank companies where these funds are invested. It is a very grave concern that investors and foreign fund managers do not take for granted or ignore. With or without ultra high interest rates, smart investors will not borrow and invest, and cautious foreign fund managers will not expose their foreign funds to the risk of total loss, under the uncertainties and dreadful possibilities of a prolonged and full-blown civil war.

The futility of the IMF-prescribed ultra high interest rate in achieving its objective—such as preventing capital flight against the backdrop of severe economic-political turmoil—was vividly shown in Indonesia in 1998. Here, despite the 65% bank lending rate and 51% time deposit rate, "Indonesia had not attracted any significant portfolio flows in the first six months of the year and net flows are about zero." [viii]

[viii] Resigned to a Weaker Yen," *Asiaweek*, July 24, 1998, p. 58.

PART II
ADDRESSING THE PROVOCATION TO HIGH INTEREST RATES DURING THE ASIAN MELTDOWN: CAPITAL FLIGHT AND CURRENCY SPECULATION

As presented at the outset, one of the chain objectives of high interest rates is to prevent local currency depreciation that can cause exchange losses to dollar-debt-ridden corporations and consequent bad loans in foreign-creditor-countries that rule IMF. The two major causes of Asian currency depreciation during the meltdown were capital flight of foreign funds and dollar speculation or hoarding that serve to reduce dollar supply for payment of foreign obligations. These two causes require different treatments because they are different. One is a controllable cause while the other one is not.

THE SOLUTION TO CAPITAL FLIGHT: NOTHING—BECAUSE IT IS NON-CONTROLLABLE; JUST WAIT AND WORK FOR THE CRISIS TO BLOW OVER

In sum, IMF-Prescribed High Interest Rates are Useless in Attracting Foreign Funds and Stopping CAPITAL FLIGHT—Because the Bait High Interest Rates Generally Do Not Fool Smart and Safety-Conscious Foreign Fund Managers Skilled in Risk Management; Those Who Failed to Go into Capital Flight in the 1997 Asian Financial Crisis and the 2008 Global Financial Meltdown Suffered from their Imprudence or Recklessness.

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IMF-prescribed high interest rates are useless in restoring investor confidence or stopping capital flight because it is not a question of profitability, it is a matter of the paramount safety of the entire principal funds that dictates the prudent thing to do—seek refuge in safe investment havens that are not lacking in the whole wide world. Truly, during economic crisis, foreign fund managers do not take the bait high interest rates because to them, at that uncertain and difficult time, ***capital flight is economic wisdom***. They flee to safe havens and return only after the crisis subsided. This is evident from the previously cited report of World Bank itself that, despite the prompt raising of interest rates, such as that done by the Philippines, there was a **$203-billion capital flight,** including cut off in banking credits, in the five affected Asian economies. Hence, IMF's ultra high interest rate was a disastrous but useless solution to capital flight during the Asian crisis.

Very High Interest Rates Instituted To Discourage Capital Flight and Attract Deposit of Foreign Funds in High Yielding Bank Deposits

	Prime Lending Rates				Bank Spreads
Asiaweek issues:	10-24-97	11-14-97	2-06-98	3-27-98	February 1998
Korea	8.50	8.50	11.50	11.50	0.8
Malaysia	9.55	10.10	10.45	12.00	1.0
Thailand	13.75	13.75	14.75	14.75	3.9
Philippines	32.00	**36.00**	25.05	24.00	10.4

Above statistics (in percent per annum) which originated from Bangko Sentral ng Pilipinas (BSP) and media, suggest that only BSP seriously took and naively followed to superfluous extent IMF's 60% high-interest-rate prescription in the Asian crisis—even if it could have resisted because, at that time, the Philippines had mere contagion crisis, it had strong economic fundamentals, it did not beg for multi-billion-dollar IMF bailout fund asked by other crisis-hit Asian nations, BSP had less punishing high-interest-rate alternatives sleeping right in its own old circulars, and countries hit harder by crisis managed to maintain interest rates at much lower levels. BSP kowtowed to IMF—***to the benefit of banks.***

At very high interest rates, local bank spreads eventually breached 20%, while countless true owners of lent-out funds—depositors—were not compensated for inflation loss. They continued to receive the same interest income of as low as 2% on their savings accounts—despite doubled bank lending rates—and suffered negative real interest rates from double-digit inflation rate. BSP made the real-interest-rate wisdom a sham in the Asian crisis—***at the expense of depositors.***

Free-market apostles IMF and BSP abhor subsidies that distort market prices, vitiate free market, and encourage wasteful consumption by subsidized sectors. Incredibly, in the Asian flu, they operated their own disastrous subsidy scheme. Locally, they forced ***three million sacrificed borrowers***, no matter how poor, to bear BSP's tight-money policy implementation cost—in the form of high interest rates, exacted from discriminated borrowers beyond the limits of sanity: in excess of their capacity to pay and up to the point of loan defaults or even bankruptcies, while more than ***70 million free-lunching non-borrowers,*** no matter how rich, equally "benefited" from BSP's policy measure but did not share in its cost, a classic case of unsound economics that culminated in ₱600 billion or 36% bad loans in the banking system—***at the expense of borrowers.***

NOTE: Indonesia was not included in the tabulation because its data were not comparable. It alone was hit by combined economic-political turmoil that constrained it to raise interest rates to as high as 65%, apparently in consideration for a $42-billion IMF bailout fund. In the Philippines, non-prime interest rates peaked at about 40%.

Despite High Interest Rates, Affected Asian Currencies Depreciated Just the Same

From a pre-crisis issue of *Asiaweek* magazine (January 24, 1997, p. 50) and corporate as well as other media reports, following were pertinent regional statistics on affected Asian currencies:

ASIAN CURRENCIES	OLD EXCHANGE RATE TO US $1.00	NEW EXCHANGE RATE TO US $1.00	EQUIVALENT OF OLD EXCHANGE RATE TO US $1.00	
	Before July 1997	As of January 1998	Before July 1997	As of January 1998
Korean Won	848.00	1,525.00	$1.00	$0.56
Malaysian Ringgit	2.47	4.35	1.00	.57
Philippine Peso	26.33	46.50	1.00	.57
Thailand Baht	25.63	53.57	1.00	.48
Indonesian Rupiah	2,364.00	10,416.67	1.00	.23

The foregoing tabulation (from page 21 of the book *Puzzlers: Economic Sting*) shows that if not immediately withdrawn from the affected Asian economies upon eruption of the crisis, foreign funds converted to and invested in Asian currencies before the crisis would have shrunk in dollar value by roughly one-half by January 1998. For example, for every US dollar converted to Philippine pesos at ₱26.33 before the crisis, when reconverted to US dollar as of January 1998, the ₱26.33 local-currency investment would amount to only $0.57, a loss of $0.43 for every dollar of principal funds originally invested.

Therefore, if high-interest-rate fixated IMF officials and economists were foreign fund managers instead who, despite the eruption of crisis in July 1997, mindlessly maintained their funds in the distressed Asian economies because of high interest income out of IMF-prescribed high interest rates—while other foreign fund managers secured their funds through capital flight—just half-year later, or by January 1998, they would have been fired for losing 43% to 77% of their principal funds! Of course, this assumes further that the banks and companies where their funds were invested did not collapse from the crisis. Otherwise, they could show neither their totally lost funds nor their red faces to their bosses and peers in their head offices.

The Philippines more than doubled its interest rates to 32% right at the onset of crisis in mid-July 1997, while Indonesia promoted ultra high rates of as much as **65%** by 1998. On the other hand, Thailand, Malaysia, and South Korea maintained their high interest rates at less than 20%. ***Despite the prompt drastic raising to more than 30% of interest rates in the Philippines*** (p. 343) ***that peaked at roughly 40%, and the abnormally highest rates instituted in Indonesia, their local currencies did not perform better than those of the neighboring crisis-hit Asian countries*** (p. 344). In fact, it was worse for Indonesia. If their local currencies ***depreciated just the same*** despite their ultra high interest rates, they did not really benefit from their greater obedience to IMF.

The economic wisdom that foreign fund managers must go into capital flight at the slightest signs of economic trouble in the host economy is not even a matter for debate. In their fixation for high interest rates, only IMF officials and economists—and amateur foreign fund managers—unskilled in fund management would ignore the need for capital flight. This point was eloquently demonstrated in the 2008 global financial meltdown that erupted in the United States. Unlike their smart counterparts in the Asian crisis who immediately took their principal funds to safe havens before it was too late, the fund managers of seven large Philippine banks failed to promptly pull out their funds from the giant Lehman Brothers, despite ominous signs of trouble in the US financial system as early as 2007. Consequently, $386 million of their investment funds in the failed institution was in limbo if not lost.[ix]

[ix] Manolo Serapio, Jr., "Philippine banks have $386 million exposure in Lehman—paper," reuters.com, September 19, 2008.

What's more, at the start of crisis, the probability of investing in a potentially bankrupt company was quite high, *as borne out by the subsequent* 75% bankruptcy rate in Indonesia's business firms.[x] In other words, at the advent of crisis, foreign fund managers could not divine which three companies (**75%**) out of every four companies (**100%**) in Indonesia would eventually **collapse** from the crisis and should be avoided as an object of investment. ***In the face of such great uncertainty, it was reckless for them to stay and gamble the safety of their principal funds in the highly troubled and risky Indonesian economy.***

THE SOLUTION TO DOLLAR SPECULATION, WHICH HIGH INTEREST RATE WAS TASKED TO FALLACIOUSLY CURE THROUGH TIGHTENING OF MONEY SUPPLY USABLE IN DOLLAR HOARDING:

CURRENCY SPECULATION CONTROL,

THE COUNTRY'S ANTI-SPECULATION SAFETY NET SINCE THE 1960s, LANGUISHING RIGHT IN BANGKO SENTRAL'S OWN ANTIQUE CIRCULARS INHERITED FROM THE DEFUNCT CENTRAL BANK OF THE PHILIPPINES, ABOUT WHICH BSP OFFICIALS APPEARED CLUELESS DURING THE ASIAN CRISIS

Central Bank chiefs from around the globe who met in Hong Kong in 1999, whose meeting was graced by US Federal Reserve Board Chairman Alan Greenspan, failed to think of the solution to currency speculation. Unknown to them, the elusive solution by way of currency speculation control has been right in Philippine central bank regulations since the 1960s, the amended version of which was BSP Circular No. 138, Series of 1997, during the Asian crisis. Sadly, and woe unto victimized Filipino borrowers some of whom went bankrupt from unbearable high interest rates that peaked at about 40%, it was not recognized and not implemented by our highly commended BSP officials even when needed most during the Asian crisis!

[x] David E. Sanger, "US and IMF Made Crisis Worse, World Bank Finds," *New York Times,* December 3, 1998, as posted to the Internet as of 2001.

"STILL NO SOLUTION, (HELPLESS) CENTRAL BANKERS SHARE GRIPES ON SPECULATION"

"Central bankers from around the globe have found no immediate solution to a question that has troubled Asian leaders for nearly two years: How to control speculators...." The Bank for International Settlements, a "Swiss-based organization, which acts as a clearinghouse for the world's central banks, organized the meeting of...monetary chiefs at its Hong Kong office. US Federal Reserve chair **Alan Greenspan** attended the meeting as part of his tour through Asia."

—AP, *Philippine Daily Inquirer,* January 13, 1999, p. B5

The problem with dollar speculation.... (Really?)

"The problem with (running after dollar speculators) is that it is difficult to distinguish between speculative and non-speculative activities, and therefore difficult to define who the dollar speculators are."

—An Expert from the University of the Philippines, October 14, 2002

What BSP failed to recognize which it even amended—its own old but still in-force currency speculation control regulation!

On sales of foreign exchange by authorized agent banks (AABs), "AABs may sell foreign exchange to residents...for any non-trade purpose, without the need of Bangko Sentral...approval, provided that: a) for sales...exceeding $25,000, the AAB shall require...supporting documents (**proof of foreign obligations—**M. L. Tecson) from the purchaser of the foreign exchange...."

—BSP Circular No. 138, Series of 1997, dated July 31, 1997

Just where was IMF's and BSP's problem in stopping dollar speculation or hoarding? Here is what they missed: How BSP Circular No. 138 could have prevented dollar speculation had it been properly implemented during the Asian crisis

Those buying dollars to pay foreign loans are legitimate businesses, not speculators. Those buying dollars but not for payment of foreign obligations because they have none are—-what else if not hoarders or speculators? They may include legitimate savers in dollars but during times of crisis when dollar demand has to be managed, they are hoarders just the same.

If speculators are without foreign obligations, they do not have proof of such obligations. Once they attempt to buy dollars and are asked by banks or forex traders to submit the required proof pursuant to BSP Circular No. 138, they cannot comply, hence they cannot buy dollars. Thus, provided properly implemented, this BSP circular would prevent would-be speculators from buying and speculating in dollars. So, where was IMF's and BSP's problem in stopping dollar speculation that, as admitted by BSP Governor Gabriel Singson himself (p. 361), BSP had to raise interest rates to 30% "middle ground" rate—compared to IMF's 60% high-interest-rate prescription—just to discourage speculators during the Asian crisis?

In Sum, the Philippine Central Bank's Currency-Speculation-Control System is One of the Less Disastrous Alternatives to High Interest Rates

BSP's available but not implemented dollar-speculation-control scheme during the Asian meltdown consisted of the following:

1. Control vs. premature dollar demand by non-speculators: exchange rate hedging, like forward cover. For a fee, those with foreign obligations but not yet due can be discouraged from prematurely paying their dollar loans (which unduly raises dollar demand) through BSP's currency risk protection program. (References: BSP Circular No. 149 dated December 22, 1997; BSP Circular No. 174 dated September 2, 1998: BSP Circular No. 261 dated October 12, 2000.) BSP failed to mandate taking of exchange rate hedging while the peso had not sunk yet to its most depreciated level, resulting in the collapse of Maynilad Water, one of the companies that suffered exchange losses.

2. Control vs. non-bank dollar speculators: documentation requirement (or proof of foreign obligations) for dollar purchases by end-users. Dollar purchases that cannot be substantiated by the required proof, like import invoices, are obviously for speculation or hoarding, therefore these should not be allowed. Without this more basic measure, banks can wantonly sell dollars to speculators, in the process bring down their dollar holdings below their limits, after which they can again buy replenishment dollars. (References: BSP Circular 138 dated July 31, 1997; BSP Circular 162 dated April 7, 1998; BSP Circular 264 dated October 27, 2000)

3. Control vs. bank speculators: cap on bank dollar holdings. With this regulation, even if banks will speculate in dollars, they can do so up to their dollar holding limits only. (Ref: BSP Circular No. 137, July 31, 1997; BSP Circular Letter, October 24, 1997; BSP Circular No. 171, August 29, 1998)

NOTE: Using ***increase-decrease on cap in bank dollar holdings*** as a monetary tool will enable BSP to minimize its dollar holdings that entail carrying cost—through raising the cap during normal times and having banks maintain high dollar holdings, then reducing the cap during critical times to have banks unload part of their dollar holdings, and thereby increase dollar supply that minimizes peso depreciation. In other words, in the economy, BSP should manage the peso supply through increase-decrease in the banking industry's peso reserves held by the central bank, as well as the dollar supply through increase-decrease on the cap in dollar holdings maintained by banks.

PART III
AVAILABLE LESS DISASTROUS HIGH-INTEREST-RATE ALTERNATIVES

Against the Backdrop of Herein Less Harmful High-Interest-Rate Alternatives, the Highly Commended Bangko Sentral Officials Appear Negligent and at Fault for their Fallacious High-Interest-Rate Solution that Caused Bad Loans and Bankruptcies During the Asian Crisis

Unknown to the adoring public and media, highly commended BSP officials, who implemented IMF's high-interest-rate cure at the previously presented abnormally highest level (pp. 343-344), were actually grossly negligent in the implementation of BSP's own antique currency-speculation-control system embodied in its Circular No. 138 dated July 31, 1997. Despite available less punishing alternatives to high interest rates, seemingly helpless BSP officials fumbled for solutions as the peso depreciated to an alarming level. BSP had to form an ad hoc Committee on Interest Rates in early 1998 to address the problem.

Exasperated, I had to ask BSP what was its problem in stopping dollar speculation when there were tools at its command that can neutralize it. My herein August 4, 2001 letter, excerpted from pages 120-122 of my book *Puzzlers: Economic Sting*, was an indictment of negligent BSP's lack of prompt and punitive action against probably the most potent dollar speculator during the Asian crisis—the commercial banking system itself under the central bank's own supervision.

FOLLOW-UP LETTER TO BANGKO SENTRAL

FOR: BSP GOVERNOR RAFAEL BUENAVENTURA Date: August 4, 2001

SUBJECT: **Pray tell, just where is the problem in stopping dollar speculation?**

With its vast powers, Bangko Sentral ng Pilipinas (BSP) can stamp out destructive dollar speculation in the banking system if only it would do everything to solve this pestering problem. Instead, for the entire duration of the Asian crisis and last quarter 2000 eco-political turmoil, it relied on high interest rates in fighting currency speculation. It did not run at all after dollar speculators, a *gross dereliction of duty* of BSP because it protected instead of punishing harmful speculators, and punished instead of protecting productive investor-borrowers—which it could have avoided by simply enforcing its existing circulars against dollar speculation. I reiterated to BSP my suggested implementation of currency *speculation* control through my June 12, 2000 letter that it received on July 20, 2000. When it finally took some initial steps to implement it in August 2000, it found 20 banks, or about half the commercial banking system, in violation! ("20 banks fined P1.2M for peso speculation," *Philippine Daily Inquirer,* August 28, 2000, page B8)

From April 1998 up to June 2001, I repeatedly suggested to BSP the taking of currency speculation control measures that can neutralize dollar speculation, such as the very first step of prohibiting it as economic sabotage, with severe punishment to violators; requiring proof of foreign obligations for dollar purchases by the public, which will automatically disallow speculative purchases as these cannot be supported by the required proof—because there are none, these purchases are speculative precisely because these are merely for hoarding, there are no foreign obligations to be paid, therefore there is no available proof; as well as reduction in the cap on bank dollar holdings, which will nullify dollar speculation by banks and constrain them, instead of BSP, to unload resulting overbought dollar balances, thereby injecting liquidity into the foreign exchange market. After long inaction, in its June 30, 1999 letter-reply, BSP rejected my suggestion and condemned it as a cure worse than the disease (page 215 of the book *Puzzlers: Economic Sting*).

At present, however, things are different. As reported in newspapers, BSP is instituting a penalty scheme against dollar speculation by banks that will complement the currency speculation control measures it activated in second-half 2000 ("Bangko Sentral moves to penalize banks engaging in foreign exchange speculation; $ overbought cap to be cut," *Manila Bulletin*, July 24, 2001, page B-1). In effect, *BSP is already implementing what it mindlessly rejected in mid-1999—which turned out in 2000 to be essentially those mandated in its old circulars inherited from the defunct central bank*—except that BSP is not doing it right.

BSP's past punitive action against dollar speculation was ineffective because it was directed primarily against the institutions or banks that can very well afford the fines from their much bigger gains from dollar speculation, not against the persons, the responsible bank officials who will be really hurt by permanent disqualification from office if not imprisonment. However, BSP's graduated penalty scheme reported in newspapers on July 24, 2001 is still not harsh to banks—it will not hurt them at all the way high interest rates hurt borrowers during the Asian crisis and impaired their financial capacity to repay bank loans! Further, BSP indirectly admitted the potency of my proposed reduction in cap on bank dollar holdings when it reserved it as the ultimate punishment for more serious or habitual bank violations. However, in so doing, BSP unwittingly imposed upon itself the time-consuming burden of proving first such violations before it can apply this potent measure on a preventive and timely basis, thereby sidelining it.

But why resort to medication when what is needed is drastic surgery? Why impose *bearable* penalties that will not really deter speculation precisely because these are bearable? Why not prescribe *unbearable* punishment right for first-time violators, so that unpatriotic bank officials will either stop their acts of economic sabotage or be disqualified permanently from office, ridding the banking system of their kind? Why have more qualms about stiff sanctions to a few dollar speculators—which, in the first place, they can easily avoid by not violating BSP regulations—than about the suffering right now of victimized 76 million Filipinos from greatly increased prices of goods and services as a result of continuing peso depreciation, the evil impact of dollar speculation?

Unless BSP will take the very first step of having dollar speculators—not just banks but also non-bankers who may operate dollar black markets outside the banking system—*punished severely as economic saboteurs*, unless it will impose the *permanent disqualification from office* of erring bank officials and a *million-peso daily fine* (or whatever high amount is deemed appropriate) for each violation by banks right for first violations, unless it will *reduce the cap on bank dollar holdings* in fast reaction to a *depreciating peso*—without the self-imposed burden of proving first any suspected dollar speculation within the banking system—it means BSP is not yet really solving dollar speculation!

The probability that BSP is indeed not really solving the dollar-speculation and corollary peso-depreciation problems the way it should be done can be deduced from an event this week. "The Bankers Association of the Philippines (BAP) said yesterday it had voluntarily agreed to reduce overbought limits on their dollar holdings (from the $10 million limit set by BSP) to $5 million or 2.5% percent of unimpaired capital, whichever is lower, effective today." According to BAP, "there was *enough dollar liquidity* in the market but it was not evenly distributed." It added that "by lowering the overbought limits, we are in effect addressing the uneven distribution by providing the market with an additional pool of funds." BAP's "own…numbers suggest it will be substantial in terms of added liquidity." ("BAP cuts dollar overbought cap," *Manila Bulletin,* August 2, 2001, pages B-1 and B-2)

What more proof does BSP need to realize that it is not doing everything to fight dollar speculation and stabilize the exchange rate? In papers acknowledged received by BSP, I have repeatedly recommended to it since July 2, 1999 the reduction in the cap on bank dollar holdings* but to this day, it has not even commented on this particular suggestion in all of its letter-replies to me, let alone implemented it. Fortunately, what BSP should have mandated as a matter of its duty but did not do so—the proposed reduction in the cap on bank dollar holdings—banks will do on a voluntary basis! BSP's gross negligence is quite clear from BAP's statement that there was enough dollar liquidity but the problem was uneven distribution, which could have been remedied by the said suggestion since two years ago to BSP—but BSP is taking forever to do it.

*[NOTE: As reported later by media, BSP eventually followed the suggested reduction of the cap on bank dollar holdings in March 2003, or *one year and seven months* after its receiving on August 7, 2001 this August 4, 2001 follow-up letter, and *three long years and eight months* after its receiving on July 2, 1999 the first of repeated recommendations to reduce bank dollar holdings during critical times. ("BSP limits banks dollar holdings, forward FX," *Manila Bulletin,* March 14, 2003, page B-1.)]

So, pray tell, just where is the problem in stopping dollar speculation? At the risk of being called ignorant or immodest, I cannot see it. If there was a problem, it was BSP-made! It was right in BSP's *holding back*—its imposing *bearable* instead of *unbearable* sanctions—against banks engaged in speculation or serving as its tool, resulting in persisting dollar speculation and the ever-present temptation to raise interest rates to uneconomical levels, as was foolishly done in the past, and might be foolishly done again soon!

As reported in today's front page of the *Philippine Daily Inquirer,* to bring the currency exchange rate to ₱50 to the US dollar by year-end in quick response to President Gloria Macapagal-Arroyo's urging, BSP Governor Rafael Buenaventura gallantly declared that "BSP…(is) prepared to raise interest rates…." (Martin P. Marfil and Clarissa S. Batino, "Gloria asks BSP to prop up peso to 50-to-$1," *Philippine Daily Inquirer*, August 4, 2001, p. A1). But why should the borrowing public suffer from BSP's continuing gross negligence in the taking of proper measures against dollar speculation?

If BSP disagrees with my proposition that there is no problem if only it would do what is necessary, will it please tell me where or what the problem is? Maybe I can suggest something now the way I did in 1998, when BSP took steps meant to ease high interest rates but "the prime lending rates of banks… remained recalcitrantly high," as shown in the attached paper, a reminder to BSP to use more common sense in finding solutions to problems.

MARCELO L. TECSON

cc: Office of the President, select legislators and members of media, etc.

NOTE: With separate but identical letters addressed to individual members of the BSP Monetary Board. Copies of the original signed version were transmitted to and acknowledged received on August 7, 2001 by the following: Office of BSP Governor and Monetary Board Chairman Rafael Buenaventura, Office of Secretary of Finance Isidro Camacho, and Offices of the following members of the BSP Monetary Board—Vicente Valdepeñas, Jr., Melito Salazar, Jr., Antonino Alindogan, Jr., Juan Quintos, Jr., and Teodoro Montecillo; copy for DTI Secretary and concurrent Monetary Board member Manuel "Mar" Roxas II was slipped under the closed door of his unmanned office at BSP.

SUMMARY OF VIABLE HIGH-INTEREST-RATE ALTERNATIVES

Drawing from my experiences as a former head of an Internal Audit group, whose responsibilities included formulation of systems and control measures to address all modes of probable wrongdoing, as well as weaknesses and deficiencies in existing internal control system and company policies and practices, hereunder were what I compiled as less catastrophic **alternatives** to IMF's high-interest-rate tight-money policy tool in its supposed role as defense against currency speculation, a form of economic sabotage or wrongdoing during the crisis. While I thought of the economic crisis itself and high loan repayment rates as additional viable alternatives, the rest are **ready-made solutions** or **standard monetary tools**. So why did BSP officials ignore them during the crisis?

1. CURRENCY SPECULATION CONTROL

First and foremost, BSP's own antique central bank regulation, issued when lawyer-economist President Diosdado Macapagal abolished currency control in the early 1960s. In substance, it is a scheme of currency speculation control embodied in BSP's amendatory Circular No. 138 dated July 31, 1997. Unfortunately for borrowers who had to suffer from BSP's shortcomings, the modern crop of BSP officials did not recognize the circular as the elusive alternative solution to currency speculation. They failed to implement it even when needed most during the entire duration of the Asian turmoil. Under this circular, at the pain of punishment, banks are prohibited from selling dollars to currency speculators, or those without foreign obligations but buying dollars merely for hoarding or speculation purposes, then will resell or convert the hoarded dollars to local currency at a profit once the local currency depreciates. The local currency depreciation comes about precisely because it is induced by the economic-sabotage dollar speculation that creates an artificial increase in dollar demand, to the detriment of the local currency.

After my repeated follow-ups, when BSP belatedly enforced currency speculation control in August 2001, the peso suddenly appreciated from ₱53.05 to ₱51.85 to the US dollar.[xi]

[xi] Fil C. Sionil, "Peso rebounds to ₱51.85 from ₱53.05 to dollar, *Manila Bulletin,* August 11, 2001, p. B-1.

Had BSP strictly implemented its Circular No. 138 prohibiting banks from selling dollars to currency speculators, dollar speculation could have been contained even without economic-folly IMF-prescribed high interest rates. The dollar-speculator-buyers could have been readily identified by banks and denied the sale of dollars because, as mere speculators who do not have foreign obligations to pay in dollars and are buying dollars merely for hoarding or speculative purposes, they could not comply with the required documentary proof of foreign obligations under the said BSP Circular No. 138.

Without knowing that it is in fact part of BSP's own long-standing regulations, I recommended the currency-speculation-control scheme to BSP under my letter personally issued to BSP officials when I attended the BSP Committee hearing on high interest rates at its head office on April 17, 1998, but it was ignored by BSP. When I issued written follow-ups, BSP condemned it as a ***cure worse than the disease*** in its June 30, 1999 letter-reply to me. After I accidentally learned (from former BSP Governor Gabriel Singson's explanation in a TV interview on October 24, 2000) that my recommendation is actually a central bank regulation, I issued to BSP officials some candid and harshly critical follow-up letters, the last of which was the previously presented letter dated August 4, 2001. I had to tell BSP that I was not wrong in my recommendation, which it called a cure worse than the disease. ***How could my recommendation be wrong when it was just asking for the implementation of what turned out to be BSP's own age-old circular, which it did not enforce even when needed most during the Asian crisis?*** BSP's failure to enforce this less catastrophic high-interest-rate alternative together with herein other alternatives—even when high lending rates peaked at about 40% during the turbulence—provoked loan delinquencies and bankruptcies to many Filipino borrowers.

When BSP was finally constrained to run after dollar-speculating and dollar-speculation-abetting banks, or those violating BSP Circular No. 138, it found practically *half of the commercial banking system in violation* of its circular. ***As a result of BSP's action against banks, the peso-to-dollar exchange rate suddenly appreciated from ₱53.05 to ₱51.85 in favor of the peso.***[xii] It is quite evident then that the unwarranted depreciation of the local currency was in large part due to BSP's failure to implement its own antique but ever-valid anti-speculation circular.

[xii] Fil C. Sionil, "Peso rebounds to ₱51.85 from ₱53.05 to dollar," *Manila Bulletin*, August 11, 2001, p. B-1; *Puzzlers: Economic Sting*, pp. 119-124.

On Hedge Funds' Speculative Currency Trading: If the Art of Warfare Changes, Why Can't that of Economics?

"George Soros, the maverick hedge fund manager… will always be remembered as 'the man who broke the Bank of England.' A well-known currency speculator… in September of 1992, he borrowed billions of dollars worth of British pounds and converted them to German marks. When the pound crashed, Soros repaid his lenders based on the new, lower value of the pound, pocketing in excess of $1 billion in the difference between the value of the pound and the value of the mark during a single day's trading. He made nearly $2 billion in total after unwinding his position…. He made a similar move with Asian currencies during the 1997 Asian Financial Crisis, participating in a speculative frenzy that resulted in the collapse of the baht (Thailand's currency). Governments lived in fear that Soros would take an interest in their currencies. When he did, other speculators joined the fray in what's been described as a pack of wolves descending on a herd of elk. The massive amounts of money the speculators could borrow and leverage made it impossible for smaller governments to withstand the assault."[xiii]

As late as the American Civil War in the 1860s, armies fought facing each other in two opposite horizontal formations. Soldiers were standing as open targets. Hence, right at the first volley of gunfire, scores fell dead or dying. By the first and second World Wars, the art of warfare was different. Infantry soldiers were no longer open targets. They dug trenches or sought cover, otherwise, they would be mowed down by the superior firepower of machine guns and automatic rifles then in use. Clearly, common sense out of extreme necessity eventually prevailed and changed the suicidal method of conventional warfare.

In economies, currencies are traded like ordinary commodities. Hedge funds speculate in the currency market because, unlike in the stock market where they wait for results beyond their control as they do not manage corporations, in currency trading, they handle the trading operations. Through their speculation, they themselves induce the local currency crash or depreciation that yields them trading profit. For example, using their deposit or credit in a US bank, they can obtain a peso loan from its Philippine branch. On their behalf, the bank branch will buy US dollars for temporary hoarding at say ₱40 to $1. Precisely because of their huge dollar buying and hoarding that

[xiii] Lisa Smith, "George Soros: The Philosophy of an Elite Investor," Investopedia, August 14, 2019.

tighten local dollar supply, the peso can depreciate to say ₱50 to $1. The hedge funds will then sell at ₱50 the dollars that they bought at ₱40, then pay the peso loan and enjoy the ₱10-profit between their buying and selling prices. If the ₱40 exchange rate before speculation was at the ideal level, legitimate businesses that bought dollars at depreciated ₱50 suffered from speculation. The harm that they suffered meant a failure of central banking.

What Do We Gain from Currency Speculation?
If Grievous Harm Rather than Benefit, then Outlaw it!

Currency trading is a normal business activity, fine, but, as in the case of the art of warfare, common sense shoul1d prevail and limit it to beneficial transactions by merchants and industrialists. It should not include economic-sabotage speculative transactions done by currency speculators who buy dollars even without foreign obligations. Harmful speculation should be prohibited, as has been done by the Philippines since the early 1960s, embodied in the crucial amendatory BSP Circular No. 138 as of July 31, 1997. Foreign hedge funds cannot obtain peso loans either from local banks for dollar speculation purposes. *Local banks are prohibited from lending to non-residents under BSP Circular No. 222 dated December 24, 1999*. Under these rules, hedge funds cannot do speculation. Thus, governments that know how to properly use their powers are not helpless against speculators.

2. EXCHANGE-RATE HEDGING ON FOREIGN LOANS

Before the crisis, IMF should have prescribed exchange rate hedging on foreign loans of dollar-debt-laden Asian corporations, to avoid the need for high interest rates in addressing inescapable exchange losses on their unhedged foreign loans once an economic crisis strikes.

Actually, IMF could have totally or substantially avoided prescribing ultra high interest rates in the Asian meltdown had it been proactive rather than reactive in the attainment of its mission. As a prime mover of currency liberalization under globalization, IMF helped promote the free flow of advanced nations' massive investment funds to developing Asian countries. The foreign fund inflow fueled the phenomenal growth of affected Asian economies before the crisis. However, as the funds were in effect direct and indirect lending to the developing nations, in the long run, there was a probability that the lending might suffer delinquencies and bad loans, especially if there were economic aberrations. Therefore, as part of IMF's planning and risk management, it should have instituted safety nets to currency liberalization, like exchange rate hedging on foreign loans granted to dollar-debt-ridden Asian corporations.

When IMF did nothing and the Asian crisis erupted, it faced an onrushing tsunami of exchange losses among dollar-debt ridden Asian companies—which could translate to bad loans in the origins of the massive investment funds that flowed into the region—the advanced nations that control IMF. To address the problem, IMF sacrificed Asian banks and borrowers through subsidy-laden, anti-market, disastrous but superfluous—in other words, technically wrong—high interest rates, culminating in huge bad loans in scourged Asian economies.

Why Hedging Was Feasible Before the Asian Turmoil, When Asian Markets Were Calm and Growing

Before the Asian meltdown, exchange rate hedging appeared feasible, especially if done with the help of central banks. As a rule, what makes hedging feasible is that, unlike in bank lending where banks have to release to borrowers the loanable funds before earning interest income thereon—with concomitant bad-loan risk in case of borrowers' business failure—in exchange rate hedging, no fund whatsoever is released to the insured debtors, yet a hedging fee is earned by the hedging institutions. Thus, hedging institutions (including central banks) can already acquire and earmark for the insured debtors the dollars needed in the future, invest the dollars and derive earnings in the meantime, and at the same time earn a reasonable hedging fee on it.

Just Because IMF Could Not Do it Did Not Mean that the Rest of Humanity Could Not Do it Either; Where IMF Officials and Economists Miserably Failed, At Least Two Filipino Wharton Business School Alumni Succeeded In Avoiding Huge Exchange Losses Through Hedging on Foreign Loans

Please see Chapter 18, pages 326 to 327, for details.

3. CAP ON BANK DOLLAR HOLDINGS

This is a safety net against dollar hoarding or speculation by banks awash in cash. If there is a limit to the amount of dollars that banks can buy for resale to their clients, any speculation will stop once banks reach their respective limits.

The limit on bank dollar holdings can be a very important monetary tool if only IMF and central bank officials would see its full potential. It can be very useful not only in curbing dollar speculation by banks but also in stabilizing the exchange rate through injecting liquidity into the foreign exchange market without cost to the central banks.

The determinants of the peso to dollar exchange rate are the available local currency in circulation and dollar supply in the economy. To defend the local currency and stabilize the exchange rate during times of crisis, IMF and central bankers have heretofore focused attention on the regulation of local currency supply through an increase or decrease in the mandated bank peso reserves. However, as the peso supply is just one side of the exchange rate equation, why myopically limit IMF's and central bankers' attention to it? Why not regulate likewise the dollar supply by increasing or decreasing the cap on bank dollar holdings, similar to increase or decrease in prescribed peso bank reserves?

During times of abundant dollar supply, the central bank can raise the cap on bank dollar holdings so that the banking system, in tandem with the central bank, can in effect maintain increased dollar reserves for the economy—without any carrying cost to the central bank.

During times of scarce dollar supply or speculative attacks against the local currency, to inject dollar liquidity into the foreign exchange market and defend the local currency, the central bank can conserve its dollar reserves by having banks unload dollars from their reserves—previously increased when dollar supply was abundant—through simply ***reducing the cap on bank dollar holdings.*** This will constrain banks with dollar balances beyond the reduced limit to sell their excess dollars, including those accumulated from undue speculation. **Once the tight dollar supply is over, the central bank can restore the higher limit of bank dollar holdings.**

The advantage of this increase-decrease in bank dollar holdings—depending on abundance or tightness in dollar supply—similar to increase-decrease in peso bank reserves, is that the central bank will not incur any carrying cost on the additional dollar holdings in the economy as these are owned and held by banks, not by the central bank.

BSP Successfully Applied the Reduction in Cap on Bank Dollar Holdings in 2003 When the Peso Became the Best Performing Currency in the Region Even Without High Interest Rates

In March 2003, or almost four years after BSP received on July 2, 1999 my earlier book manuscript that proposed this repeatedly suggested measure—increase-decrease in the cap on bank dollar holdings—BSP implemented it along with its already existing intensified drive to enforce documentation requirement for dollar purchases beyond the $5,000 exempt limit.[xiv] As seen, the Philippine peso achieved the rare feat of being the best performer among Asian currencies that appreciated against the dollar owing to the US-Iraq war.[xv]

4. THE ECONOMIC CRISIS ITSELF

The economic crisis itself serves as a tight-money supply stimulus that renders the high-interest-rate tight-money policy tool superfluous. The crisis provokes economic slowdown, wait-and-see attitude by investors, lack of appetite to borrow more by borrowers still amortizing their existing loans, discouraged spending by consumers, and capital flight of foreign funds, all of which work to drain any excess liquidity in the economy.

5. QUANTITY RATIONING IN LIEU OF PRICE RATIONING

Quantity rationing is a tight-money policy tool, under which the central bank issues a circular mandating a drastic reduction in loan value of finite collateral. Even without high interest rates, quantity rationing can minimize the volumes or amounts of new loans from the available borrowers' collateral, resulting in tight money supply usable in dollar speculation and inflationary spending. Thus, it is an alternative to price rationing, or high interest rates that similarly reduce new loans through prohibitive borrowing costs. An example of a BSP circular that reduced the loanable value of borrowers' collateral was BSP Circular Letter dated May 6, 1997. It reduced from 70% to not more than 60% of appraised value the loanable amount of real estate offered as loan collateral. As quantity rationing, the 60% loanable value could have been reduced further to 30% in lieu of ultra high interest rates during the Asian flu.

[xiv] Fil C. Sionil, "BSP limits banks dollar holdings, forward FX," *Manila Bulletin,* March 14, 2003, p. B-1.

[xv] Clarissa S. Batino, "Peso sustains rally, still Asia's best performer," *Philippine Daily Inquirer*, March 28, 2003, p. B1.

During the Asian crisis, despite the availability of **quantity rationing** as an alternative that could have been used to totally avoid—or at least reduce—the high interest rates prescribed by IMF and induced by central banks, this was not done. Instead, IMF prescribed 60% ultra high loan rate and BSP instituted the 30% middle-ground high rate. To quote BSP Governor Gabriel Singson from the special report "Bangko Sentral chief: Worst is Over" on page 9 of the June 1999 issue of the business periodical *MarketWatch*: *"Jeffrey Sachs was hired by... NEDA... to conduct a study soon after the (Asian) crisis started and his recommendation was to bring down interest rates to **4%**, never mind the exchange rate. The IMF said bring up interest rates and stabilize the exchange rate. I adopted the **middle ground**. In January 1998, bank lending rates were at 30% to 31%."*

6. HIGH LOAN REPAYMENT RATES

Instituting high loan repayment rates is another unused tight-money measure. It increases loan amortization to banks as a way to siphon off any excess liquidity in the economy. But the increase in amortization should be treated and recorded as ***loan principal repayment*, *not*** unjust and unwarranted interest expense. The reason is plain common sense: what is needed is simply a restriction in the ***physical flow*** or circulation of cash in the economy, ***not a transfer of ownership*** from borrowers to creditor-banks of the increase in loan amortization. The absurd ownership transfer is the result of erroneously treating the additional amortization as interest expense.

During an economic crisis, when IMF imposed tight-money policy to nations under its sway, central bankers will drain liquidity in the **spending sector** of the economy through promoting a hike in loan amortization from borrowers to banks by way of high bank lending rates. The high loan rates are usually provoked by an increase in central bank key policy rates. The additional amortization is treated as debtors' ***interest expense***, therefore its ***ownership is transferred*** from borrowers to banks.

Then, when the same central bankers want to avoid excess liquidity in the **banking system** resulting from the increased loan amortization to banks, they mandate an increase in reserves kept by banks with the central bank. However, this time, the hike in reserves is treated as ***deposits*** owned by the banks. In which case, unlike the increase in borrowers' loan amortization, the deposit ownership is not transferred from the banks to the central bank. Why this utterly discriminatory double standard against borrowers in favor of banks? What convoluted economic wisdom justified it? Why did highly commended—but seemingly clueless—BSP officials blindly implement it instead of questioning IMF for it?

In tightening the money supply, the present system of treating as borrowers' interest expense the stimulated increase in loan amortization (done through raising interest rates) is not tenable from the standpoints of law, morality, and sound economics—because in reality the increase in amortization is not cost of borrowing money for the benefit of borrowers. It is the cost of implementing a government economic solution for the benefit of the nation, instituted by the thoughtless central bank in pursuit of its mandate. Therefore, such cost should be borne not by borrowers alone but by the entire benefiting nation—under a system which, if IMF and central bank economists cannot conjure, should be developed by outside systems experts on an ad hoc consultancy basis.

In essence, what I am referring to is the fundamental philosophy that serves as a standard of fairness, the generally accepted ***benefit principle*** of taxation, under which ***a cost for the benefit of the nation should be borne by the nation*,** not by the discriminated borrowing sector alone. However, did IMF and central bank officials and economists have to be told about this obvious and common-sense economic wisdom? Was following it not instinctive to them?

How the reduction in money supply (by way of increase in borrowers' loan amortization to banks) is treated in the books of banks and borrowers—whether loan principal repayment or interest expense of borrowers—makes no difference to IMF's and central banks' tight-money-supply objective because what matters is the **physical reduction** in money supply, not its treatment or manner of **recording**.

Therefore, how the IMF-prescribed reduction in money supply happened to be treated and recorded as borrowers' interest expense no matter how substantial, confiscatory, impoverishing, and unconscionable the stimulating high interest rates were, was simply mind-boggling**!** It was as though exalted economists in IMF and central banks were so bankrupt in ideas and creativity that they could not tighten money supply, or curb currency speculation, in crisis-hit economies of nations without slaughtering through high interest rates their borrowing sectors.