William J McDonough: The foundation of financial stability

Speech by Mr William J McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York, before the 50th Anniversary Symposium of the Bank of Korea, held in Seoul, on 8 July 2000.

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It is a true honor to address you today on the occasion of the 50th anniversary of the Bank of Korea. I regret that I am unable to join you personally in your celebration.

The past half-century has been one of tremendous challenges and outstanding achievements for Korea, to which even a short list of developments testifies: national rebuilding after the devastations of the Korean War, the economic miracle, democratization and the emergence of a modern, urbanized and well-educated population. Indeed, given initial conditions, Korea might be considered the biggest success story of the last 50 years. This record reflects the long Korean history of resilience in the face of external threat, the hard work and energy of the Korean people, and the adoption of new models in response to environmental change.

The Bank of Korea has played a key role in Korea's economic success. In the early stages of development, the Bank acted to facilitate the state-led growth model. The Bank's role evolved as the economy became more market-driven over time, and the amended Bank of Korea Act further enhanced the independence of the central bank and enshrined price stability as the primary objective of monetary policy.

The economic crisis that began in 1997 represents the latest national challenge. True to historic form, Korea has responded decisively and vigorously to that challenge, with the Bank of Korea playing a critical role in the overall effort. A strong case can be made that, of all the countries affected by the broader crisis in the emerging markets, Korea has gone furthest to repair the damage and institute underlying reforms to prevent future crises. That said, in Korea and elsewhere, the recovery is not yet complete, and more remains to be done.

The depth, breadth and rapidity of economic and technological developments of the last several years clearly underscore the increasingly international nature of policy challenges, and the dramatic transformation of the international financial landscape. The intensified integration of markets - reflecting the globalization of capital, production and labor - has increased the risk of contagion, making it virtually impossible for any country that wants to be part of the global trading system to insulate itself from external forces.

The crisis and the recognition that we have entered a new environment have set in motion a range of efforts dedicated to building a new international financial architecture. My remarks today will focus on what I believe can be done, from my perspective, to enhance domestic financial resiliency, within the context of these international efforts, and particularly on two essential building blocks: a strong financial system and a sound and stable macroeconomic environment. My comments reference the experience of East Asia, but reflect lessons that are more broadly applicable.

Overview of recent recovery

Given the depth of the problem a little more than two years ago, the Asian recovery on the whole is remarkable, and has largely defied initial expectations that the crisis would cast a long shadow over regional growth prospects. The regional recovery exhibits a solid "V" shaped trajectory supported by strong performance in the external accounts, but with more recent improvement in domestic demand. Banking sectors - faced with unprecedented crisis two years ago - have been shored up through substantial capital injections and problem asset carve-outs. Corporate sector conditions also appear to have improved notably with the advent of recovery and debt restructuring efforts.

At the same time, authorities in a number of Asian countries initiated a wide range of fundamental enhancements to financial system infrastructure, including strengthening prudential regulation and supervision, bolstering bankruptcy and collateral recovery processes, and improving disclosure requirements. With the full implementation of these measures, standards in Asia will closely approximate international norms.

Complacency

In light of these achievements, there is much to be optimistic about. But we must all guard against complacency and reform fatigue, which represent a significant risk to sustained recovery.

Crises entail wrenching change and costly solutions that are difficult to bear over a long period. The desire for a return to "normalcy" is strong. Under these conditions, it is human nature to overemphasize positive information, tire of reform, declare victory and move on. These impulses might be expected to be particularly powerful against the backdrop of years of strong and unbroken Asian economic growth.

It is no wonder therefore that governments the world over initially tend to underestimate the size of problems, underfund solutions and postpone loss recognition. It also is not surprising that, given the many obstacles involved, authorities may be tempted to prematurely mark a case closed, particularly with the advent of economic recovery.

In the new international financial landscape, a government's perceived ability to deliver on the policy front is crucial, preferably based on coherent, comprehensive and achievable objectives. Confidence in a government's ability to deliver is nurtured both by actions and by communication. Complacency and reform backsliding, however, create the dangerous potential for a shift in expectations.

Vulnerabilities

Indeed, while the recovery in the region has been impressive, vulnerabilities remain, both at the micro- and macroeconomic levels.

On a microeconomic level, the still fragile condition of regional financial and corporate sector institutions remains a vulnerability, and a real threat to medium-term stability.

Notwithstanding significant official rescue efforts, regional financial sectors remain burdened by a high level of problem loans, and require further substantive bolstering of capital and reserves. Authorities, by and large, have yet to articulate a program for reprivatizing banks and liquidating purchased assets. Improvements in the financial system infrastructure depend critically on follow-through on these issues, a long-term process.

Corporate sectors similarly remain fragile: recent debt restructurings have involved a high degree of debt rescheduling, and firms across the region remain burdened with significant amounts of debt. The relatively limited restructuring of corporate operations to date across the region raises questions about the medium-term sustainability of recent improvements in bank asset quality.

The relative lack of breadth in the region's recovery also creates vulnerabilities. Asia's export orientation has long been a key focal point of strength, to which the recent recovery attests. However, too great a dependence on export-driven growth brings increased vulnerability to external shocks. While current account surpluses have been substantial, this potential engine of growth could be slowed over the medium term through pressures on domestic currencies to appreciate, and through the ongoing reversal of the dramatic import compression witnessed following the crisis.

The recent pickup in domestic demand is a positive sign of more balanced growth - sustained by notable monetary and fiscal stimulus - which will need to be steadily unwound as recoveries take firmer root. Regional central banks will be particularly tested as they seek to implement new monetary policy anchors, in some cases with new-found independence.

Unfinished business

Events of the recent past have amply illustrated that weak financial systems are an expensive and dangerous vulnerability, particularly for countries that rely on foreign capital to help support their investment and growth. Financial sector weakness was at the heart of the problems in Asia, a crucial element in Argentina and Mexico earlier in the decade, and a contributing force in Russia. Just as strong financial systems act as stabilizers when a domestic economy is battered, weak financial systems amplify the scope and reach of the problems, making bad situations worse.

While important progress has been made in rehabilitating Asia's financial systems, a great deal remains to be done to continue the strengthening of weakened financial and corporate sectors, and improve the region's resistance to future problems.

I am well aware that universal policy prescriptions are difficult to draw, given the wide range of experience and initial conditions. Indeed, individual countries in Asia have followed differing reform strategies, and the results of these efforts will help to inform the ongoing debate. Nonetheless, international experience with financial sector reform suggests a number of cautionary lessons. Let me cite a few:

- *Restructuring and reform must adequately address both the current "stock" of problem assets as well as the potential "flow" of new problems attributable to deficiencies in the broader financial system infrastructure.* Lack of adequate action on either front can lead to a continuation of the substantial costs of weak banking sectors, sometimes well beyond the immediate crisis itself.
- *Clean-up efforts must be sufficient to the task.* Half-done measures that leave financial institutions with significant levels of impaired assets at best postpone the reckoning and potentially create incentives for excessive risk-taking.
- Fundamental improvements in bank corporate governance are critical. Just as risk management and internal control processes usually need to be thoroughly overhauled in weak institutions, more often than not, so too does management.
- *Protracted forbearance to preserve the appearance of solvency is not a solution.* While some degree of forbearance may be unavoidable and even appropriate under the right conditions, it is at best a temporary measure. It is critical that forbearance does not become institutionalized, but is tied directly to actions by both bankers and supervisors to address underlying problems.
- *Governments are not good long-term asset managers.* Prolonged government holding of impaired assets is not likely to enhance their value nor aid in the restoration of market liquidity.
- *Governments are not good commercial bankers*. Delayed privatization of nationalized banks always means higher future costs and usually inhibits fundamental reform.
- *Government-directed lending means future fiscal losses.* Similarly, efforts to stimulate credit growth by non-market forces in the context of a banking crisis at best buy additional time and usually dig a deeper hole.
- *Foreign investment in domestic financial sectors can yield important benefits.* Foreign direct investment in the banking sector can provide much-needed capital resources, technology and knowledge transfer, and a more diversified capital and funding base in the event of future economic instability.
- *Financial sectors are only as healthy as their borrowers.* Without corresponding corporate sector restructuring, financial sector rescue efforts are likely to be necessary in the future.
- *Unbalanced financial systems create vulnerabilities.* Financial systems that are unduly reliant on banks for financial intermediation are likely to be more vulnerable and slower to

recover from the onset of weakness. Shallow capital markets limit lending alternatives and delay the recovery of financing to the real sector.

The challenges can be daunting, but recent experience both within and beyond Asia confirms that a dedicated commitment to financial reform contributes to greater crisis-resilience and longer-term financial stability. While financial sector rehabilitation will remain a key priority for authorities in Asia, longer-term measures need to be put in place to deal adequately with the increasingly complex and dynamic international financial marketplace of the 21st century. The threats to financial stability are many, and no one set of measures can be expected to ensure against the recurrence of future problems. Financial intermediation is a constantly evolving activity, involving new risks, instruments and control challenges. Financial institutions and policymakers alike need continually to upgrade their processes to remain in command of these risks. To that end, it is imperative that new standards not be developed to "fight the last war", but be sufficiently robust to meet new challenges in a dynamic way.

Stability ultimately can be served only by the collective interaction of the three pillars of:

- sound leadership at the firm as well as at the national level;
- effective market discipline; and
- strong prudential regulation and supervision.

Sound corporate governance at the firm level is the first bulwark against financial system instability, and begins with capable and experienced directors and management, a coherent strategy and business plan, and clear lines of responsibility and accountability. The execution of overall objectives must be supported by rigorous internal controls and effective risk management. The importance of a strong institutional credit culture cannot be stressed enough.

Strong private balance sheets contribute to a strong national balance sheet. Recent experience underscores the importance of prudent management of liquidity risk. Clearly, reducing public sector short-term borrowing is often an essential (and generally well-acknowledged) part of the solution. To encourage improved private sector liquidity, authorities need to review the broader policy mix and identify and remove incentives that favor excessive short-term capital flows, as well as identify and remove barriers to longer-term and/or equity capital flows.

The second line of defense is effective market discipline, an increasingly important ally of policymakers in a global marketplace. Of course, market discipline must be supported by substantial disclosure, sound accounting standards, and an efficient and credible legal framework. On the last point, while some foreign investors have too frequently made allowances for "special" local practices during periods of economic boom, only strong and proven attitudes towards law, taxation, disclosure and the like provide the kinds of protections most long-term investors want and should insist upon.

While effective bank-level management and meaningful market discipline are crucial elements of an overall strategy for promoting and preserving financial stability, neither can substitute for the critical role played by official supervision. The Basel Committee on Banking Supervision, which I chair, has identified the necessary ingredients of sound supervision, and these principles must be applied to all internationally active banks within a more dynamic, risk-based and process-oriented framework.

The role of a sound and stable macroeconomic environment

A sound and stable macroeconomic environment is also crucial for financial stability, and more generally for promoting sustainable growth. The converse - macroeconomic overheating - raises the likelihood of an eventual crisis, first by promoting excessive, and eventually unsustainable, external and internal borrowing. The next step inevitably is the correction to the real economy, interest rates and/or the exchange rate, that can sharply worsen asset quality and expose the accumulated weaknesses in the financial system.

Role of central banks in promoting stability and growth

A central bank's most important role in achieving stable, long-term growth involves promoting price stability. Achieving long-run price stability is a difficult and continuous challenge, as it requires constant efforts first to detect and then to correct the building up of internal and external imbalances. Moreover, because of time lags in policy effectiveness, authorities often have to take action based only on partial evidence, well before adverse symptoms are fully evident. The principal reward for forward-looking policy is that changes in policy, and associated stresses they engender, are generally smaller and more easily assimilated by markets. The effectiveness of monetary policy naturally brings us to the question of monetary and exchange rate regimes.

A great deal has been said in various forums about the choice of monetary and exchange rate regimes. I believe it is crucial that there be consistency between a country's choice of currency regime and its other policies. There is no "right" regime that applies to all cases and all points in time. Experience has shown that no currency arrangement can compensate indefinitely for imperfections elsewhere in an economy, such as weaknesses in financial supervision, an excessively loose fiscal stance or inflexible wages and prices. Furthermore, no exchange rate regime can offer full insulation from cross-market spillovers, particularly where the free movement of capital is allowed. Nevertheless, certain policy combinations can make things far more dangerous. Fixed, but adjustable, regimes look to be particularly fraught with perils when combined with shortcomings elsewhere, not the least of which are the severe after-effects that always seem to follow their forced abandonment.

Official reserves can, at times, play a helpful role in the equilibrating process under either fixed or managed floating rates, but considerable caution is needed here. Clearly, large-scale sterilized intervention has a poor track record as a crisis avoidance tool. To be sure, history is replete with examples of how quickly a once comfortable reserve cushion can dissipate when countries attempt to buy stability rather than earn it by adjusting policy. Nonetheless, markets often seem to take comfort when authorities are perceived to step in with "judicious" market smoothing. Here again, credibility is key in assuring market participants that the central bank's focus is on preventing disorderly markets rather than on trying to manipulate market prices.

As you are aware, much of the emerging world has moved toward floating rates in recent years. For those countries that have made the change in East Asia, it would appear that the new monetary/exchange regimes, despite their very difficult starts under the most inauspicious of circumstances, now appear to be serving countries well. Inflation is in the very low single-digit range in all of the newly floating economies, and in many instances the successful effort to bolster monetary credibility has been reflected in short-term interest rates that have declined to historically low levels. Moreover, authorities have gained new degrees of freedom to manage their economies and to respond to changing internal and external circumstances.

But if the promised benefits of monetary discretion are to be fully realized going forward, markets need to understand the objectives and the framework by which the monetary authorities will decide future policy actions.

In this regard, I would note that some countries have looked to inflation targeting as a framework to accomplish that end. And indeed, inflation targeting would seem to have much to recommend it, provided that it is approached not as a panacea, but rather as a pragmatic organizing framework for policy. In other words, policy frameworks such as inflation targeting can be useful where they signal a disposition towards continuous and predictable communication, and a forward-looking, informative policy approach. But as I said, inflation targeting per se is not a sure-fire solution - for example, the costs of disinflation do not appear to be lower in inflation-targeting countries - nor is it a prerequisite for effective communication and ultimately effective policy.

Role of fiscal policy

Clearly, crisis prevention through promoting stable and sustainable conditions in the macro economy is not solely the province of central banks. Sound fiscal policies are needed to complement the effectiveness of even the soundest monetary policies. Chronically loose fiscal policy is a persistent

threat to macroeconomic stability through the build-up of internal and/or external debts that can be devastating.

For the countries of East Asia, the public sector's generally low initial indebtedness provided important latitude for dealing with the recent crises. Governments had room to stimulate aggregate demand recovery through fiscal ease; moreover, extensions of public guarantees and capital helped to contain the banking crises.

However, while initially strong fiscal positions may have provided a sort of "spare tire", as with any spare tire, it is risky to ride on it for too long, in part because it may be needed to deal with the next nail in the road. Public debt has already risen markedly in a number of countries, and contingent liabilities often remain significant, raising some concern about potential future debt growth.

Thus, some governments now face the challenge of moving to retighten fiscal policy while preserving growth and stability and, over the longer term, gradually restoring their previously strong net debt positions. These considerations further underscore the importance of quickly completing the process of banking sector rehabilitation and of attracting new sources of capital. Such decisive action would allow the banking sector to again be an engine of growth, capable of offsetting the eventual withdrawal of fiscal stimulus.

Improved transparency can help

Achievement of the goals of corporate and financial restructuring, and of macroeconomic stability, are fostered by improved transparency. When authorities clearly explain the objectives or concerns that lie behind their policies, they greatly increase the likelihood that markets will move in a direction that supports, and even favorably anticipates, the authorities' goals. Under the auspices of the IMF useful standards have been promulgated for transparency with regard to macroeconomic data, including international reserves, and for fiscal and financial policies.

As part of the improved disclosure of policies and intentions, timely and comprehensive dissemination of the public sector's balance sheet and income statement clearly is necessary if market turbulence is to be reduced. Such disclosure helps identify pressures or problems that might otherwise be allowed to fester. For example, more timely, continuous and comprehensive release of data on foreign exchange reserves may encourage earlier and appropriate policy action in the face of large-scale speculative pressures.

Transparency is most effective when it is an established element in a clearly articulated, goal-oriented process. Sensitivity to the changing needs of the marketplace for information - both statistical and qualitative - can be developed only through an ongoing dialogue with market participants. Experience suggests that in today's 24-hour trading environment with instantaneous access to information everywhere, authorities are well-advised to speed up their disclosure and explanation of their actions and intentions.

Conclusion

In closing, the recovery in Asia, and particularly Korea, is remarkable indeed, and owes much to the energy and hard work of its people, enlightened political leadership, and the substantial and focused efforts of policymakers to implement sound macroeconomic and financial policy. But the recovery is not yet complete and much remains to be done. Moreover, the rapidity and severity of the developments of the last several years, indicative of the transformation of the international financial landscape, underscore the importance to crisis prevention of ongoing vigilance and robust institutional structures, and the awareness that we can never let our guard down.

While the crisis did substantial damage, it has not fundamentally affected Asia's prodigious economic strengths. But if Asia is to realize its potential, it is critical that authorities attend to the unfinished business that remains while continuing to put in place longer-term measures to promote financial resilience and sustainable growth. Asia is at an important crossroads and there is now a unique

opportunity to consolidate recent reforms and implement lasting change that will pay dividends for years to come.

Korea's history, both longer-term and more recent, gives me every confidence that your country, assisted ably by the Bank of Korea, will rise to these challenges with skill and vigor, ensuring that the next 50 years will be even more successful than the last.

Thank you for your kind invitation and attention. Supported by the miracles of modern technology, I would be happy to take any questions you may have.