Alan Greenspan: Global challenges

Speech by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, at the Financial Crisis Conference, Council on Foreign Relations, held in New York, on 12 July 2000.

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I would like to thank you for the opportunity to address this distinguished audience this evening. The issues you have raised these two days are as interesting and timely as they are challenging.

The evidence in recent years has become increasingly persuasive that the greater is the degree of openness in cross-border trade in goods and services, the faster will be the rate of growth of an economy and eventually the higher its standard of living. What we do not know for sure, but strongly suspect, is that one major reason for the continued rapid growth in world trade is the accelerating expansion of global finance. This acceleration itself appears to require ever-newer forms and layers of financial intermediation.

Certainly, the emergence of a highly liquid foreign exchange market has facilitated basic forex transactions, and the availability of a wider array of financial instruments has allowed the development of more complex hedging strategies that have enabled producers and investors to better allocate risk. This owes largely to the ability of derivatives and other modern financial products to unbundle complex risks in ways that enable each counterparty to choose the combination of risks necessary to advance its business strategy and to eschew those combinations that do not. More efficient allocation of risk facilitates portfolio investment strategies, enhances the lower-cost financing of real capital formation on a worldwide basis, and hence leads to an expansion of cross-border trade in goods and services and rising standards of living.

Notwithstanding the demonstrable advantages of what can aptly be described as a new international financial system, the Mexican financial breakdown in late 1994 and the recent episodes in East Asia and elsewhere have raised questions about the inherent stability of this new system. More disturbing has been our inability to anticipate these crises in advance. Of course, something in the nature of such events may preclude their being foreseen, in that the market forces that produce a crisis would likely fend it off if it were anticipated. However, even if we are not able to readily forecast an erosion in the level of confidence, we may at least have the capacity to put preventive, financial shock-absorbing measures in place, thereby lowering the probability of the onset of crisis.

With this motivation, those of us active in evolving global markets - whether as private sector participants or as policy officials - have been endeavoring to understand the sources of instability that have flared up at times in recent years. It certainly appears to be the case that many open emerging market economies that have become active participants in the global economy over the past decade or so were exposed to a huge expansion in capital inflows that their economic and financial systems were not yet ready to absorb. These flows had been engendered by the increasing diversification out of industrial country investment portfolios, induced in part by significant capital gains prior to the onset of the crisis in East Asia. Net private capital inflows into emerging markets roughly quadrupled between 1990 and 1997. Such diversification was directed particularly at those economies in Asia that had been growing so vigorously through the 1970s, 1980s, and into the 1990s - the so-called “Asian tigers”. In the event, these economies were ill-prepared to absorb such volumes of funds, especially, as I shall shortly argue, because there were inadequate alternatives to banks for financial intermediation backup. More generally, there were simply not enough productive investment opportunities to yield the returns that investors in industrial countries were seeking. It was perhaps inevitable then that the excess cash found its way in too many instances into ill-conceived and unwisely financed ventures, including many in real estate.

What appeared to be a successful locking of currencies onto the dollar over a period of years in East Asia led, perhaps not unexpectedly, to large borrowings of relatively cheap dollars that, in turn, were lent unhedged, at elevated domestic interest rates that reflected unheeded devaluation risk premiums. When the extent of such unhedged dollar borrowings finally came to be recognized as excessive, as was almost inevitable, the exchange rate broke.

Although it might seem that the full consequences were predictable, they were not. Problems with imprudently financed real estate investments emerge with chronic frequency around the globe without triggering the size of the collapse experienced in East Asia in 1997. In the case of the East Asian economies, the magnitude of the crisis became evident only when the normal economic buffers that are available to absorb shocks were so readily breached under pressure.

It has taken the long-standing participants in the international financial community many decades to build sophisticated financial and legal infrastructures that buffer shocks and limit systemic fallout from market disturbances. Those infrastructures discourage speculative attacks against a well-entrenched currency because financial systems are robust and are able to withstand vigorous policy responses to such attacks. However, the institutions of the newer participants in global finance had not been tested, until recently, against the rigors of major league pitching, to use a baseball analogy.

These recent crises have underscored certain financial structure vulnerabilities that are not readily assuaged in the short run but, nonetheless, will be increasingly important to address in any endeavor to build formidable buffers against financial stress. Among the most important, in my judgment, is the development of alternatives that enable financial systems under stress to maintain an adequate degree of financial intermediation even should their main source of intermediation, whether banks or capital markets, freeze up in a crisis.

The existence of multiple avenues of financial intermediation has served the United States well in recent decades, especially during the credit crunch of the late 1980s and more recently when our capital markets froze up in 1998 following the Russian default. As I indicated in a World Bank/IMF seminar last year, for a time following the Russian default not even investment-grade bond issuers could find reasonable takers. Although Federal Reserve easing in the midst of this turmoil doubtless contributed to improved conditions, it is not credible that our actions provide the whole explanation for the dramatic restoration of most, though not all, markets in a matter of weeks. The seizure appeared too deep seated to be readily unwound solely by a cumulative 75-basis-point ease in overnight rates. Arguably, at least as relevant was the existence of financial institutions, especially commercial banks, that replaced the intermediation function of temporarily disrupted public capital markets.

In the United States, as corporate debt issuance fell under these circumstances, commercial bank lending picked up, helping to fill in much of the funding gap. Even though bankers also moved significantly to limit risk exposure, previously committed lines of credit, in conjunction with Federal Reserve ease, provided an important partial backstop to business financing.

Conversely, when American banks seized up in 1990 as a consequence of a collapse in the value of real estate collateral, the capital markets, largely unaffected by the decline in values, were able to substitute for the loss of bank financial intermediation. Without the availability of financing through the capital market, the mild recession of 1991 likely would have been far more severe.

Multiple sources of intermediation are not strictly an American phenomenon, of course. Sweden, for example, also has a corporate sector with a variety of non-banking funding sources. The speed with which their financial system overcame an early 1990 real estate crisis offers a stark contrast with the long-lasting problems of Japan, whose financial system is the archetype of financial intermediation that relies almost exclusively on banks. This leads one to wonder whether East Asia’s recent problems would have been less severe had those economies not relied so heavily on banks as their principal means of financial intermediation. One can readily understand that the purchase of unhedged short-term dollar liabilities to be invested in Thai baht domestic loans (counting on the dollar exchange rate to hold) would at some point trigger a halt in lending by Thailand’s banks. But did the economy need to collapse with it? Had a functioning capital market existed, the outcome might well have been far more benign.

Before the crisis broke there was little reason to question the three decades of phenomenally solid East Asian economic growth, largely financed through the banking system, so long as rapidly expanding bank credit outpaced lagging losses and hence depressed the ratio of non-performing loans to total bank assets. The failure to have alternative forms of intermediation was of little consequence so long as the primary means worked. That is, the lack of a spare tire is of no concern if you do not get a flat. East Asia had no spare tires. The United States did in 1990 and again in 1998.

Banks, being highly leveraged institutions, have, throughout their history, periodically fallen into crisis. When these institutions were the sole source of finance, their difficulties often pulled their economies down as well. One can wonder whether in 19th century America, when banks were also virtually the sole intermediary, the numerous banking crises would have periodically disabled our economy as they did had alternative means of intermediation been available.

Regrettably, even with our best efforts, multiple intermediation buffers and other long-term initiatives cannot be created and implemented overnight. Efforts in that direction fortunately are being furthered among a number of emerging economies. In the interim, it is essential that we employ the current period of relative international financial stability to address as best we can some of the more evident short-run potentials for crises. To repeat, we do not, and probably cannot, know the precise nature of the next international financial crisis. That there will be one is as certain as the persistence of human financial indiscretion. We can be reasonably sure that it will not be exactly the same as past crises. Crises never are the same because market participants do not, as readily as supposed, repeat their mistakes of the past. Therefore, we need flexible institutions that can adapt to the unforeseeable needs of the next crisis, not financial Maginot Lines that endeavor to fend off revisiting previous crises that will not be replicated.

While we may not be fully knowledgeable about all of the ramifications of our new international financial structure, some characteristics have become increasingly apparent. First, there are no signs as yet that the globalization process is about to stop or, excluding the one-off effect of the introduction of the euro, even slow down perceptibly in the immediate future. The consequent risks are unavoidable. Thus, we need to proceed expeditiously with the tasks of designing and implementing those improvements in both the short-term and the long-term buffers that have a reasonable prospect of protecting the international financial architecture in the years ahead.

Extensive efforts of recent years to bolster our international financial structure through enhanced regulatory supervision have too often proved ineffective. Fortunately, there are good reasons to believe that properly structured, the markets themselves can provide the self-correcting discipline that is so necessary to financial stability. However, for markets to perform this job, participants need to have information about counterparties and market leverage, for example, and this information must be relevant, timely and accurate.

A high level of transparency in the way domestic finance operates and is supervised is essential if investors are to make more knowledgeable commitments and supervisors are to judge the soundness of such commitments by the financial institutions that they supervise. I find it difficult to believe, for example, that the crises in Thailand and Korea would have been nearly so virulent had their central banks published data prior to the crises on net reserves instead of the not very informative gross reserve positions only. Some private capital inflows would almost surely have been withheld, and policymakers would have been forced to make hard choices more promptly if evidence of difficulty had emerged earlier.

Better information and greater transparency, however, are not enough. The right incentive structure has to be in place as well. Private capital markets are the fundamental building block of the capitalist system of resource allocation across activities and over time. Such markets can function properly only if investors bear the costs of their bad decisions and bad luck and reap the benefits of their good decisions and good luck. That is, if risky investments to emerging market economies, for example, turn out poorly - as risky investments are wont to do on occasion - governments or international financial institutions should not endeavor to shield investors from loss. This is as it should be, since investors earn premiums to compensate for the risks of such investments. Efforts to bail out investors, no matter how well intentioned, run the danger of encouraging excessive risk-taking down the road by, in effect, overcompensating risk bearing.

Despite the increased sophistication and complexity of financial instruments, it is not possible to take account in today's market transactions of all possible future outcomes. Markets operate under uncertainty. It is therefore crucial to market performance that participants manage their risks properly, and this is true at the national and official levels of both industrial and developing countries as well as at the level of individual private-sector firms. To the extent that policymakers in industrial or emerging economies are unable to anticipate or evaluate the types of complex risks that the newer financial technologies are producing, the answer, as it always has been, is less leverage - that is less debt, more equity and hence a larger buffer against adversity and contagion.

The type of investment instruments issued also can help contain financial stresses. It is no doubt more effective to have mechanisms that allow losses to show through regularly and predictably than to have them allocated by some official entity in the wake of default. In the former case, the private sector will be better able to price risk, making the judgment about new credit decisions more informed. This is particularly so in the international arena, where national sovereignty severely limits the reach of national bankruptcy laws as well as the scope for any realistic hopes for international bankruptcy procedures.

It is worth noting that many existing investment instruments already have such desirable properties. Capital losses on equities, for example, spread the costs of the Asian crisis across issuers and investors. From June 1997 through the trough of the crises in August 1998, emerging market equity losses worldwide are estimated to have been more than $1 trillion. At the same time, the scope for downward revisions to dividends during a crisis allows issuing firms to cushion some of their cash flow pressures. Moreover, over the same June 1997 to August 1998 period, losses to foreign investors in emerging market fixed income instruments amounted to $80 billion. I might note that with a flexible exchange rate regime the value of investments in local currency debt will fluctuate with the value of major foreign currencies such as the dollar, allowing for additional regularity in price adjustment.

Private market processes have served this country and the world economy well to date, and we should rely on them as much as possible as we go forward. This is not to say that the official sector will have no role to play in the next global crisis, or the one after that. Official safety nets and interventions cannot be eliminated entirely. There are limits to the size and extent of the shocks that the private sector can manage, at least in the short run, without official assistance. However, official financial support should be kept to a minimum for reasons of fiscal prudence, resource allocation efficiency and avoidance of moral hazard over the long run.

There is, of course, in any economic system the necessity for sound monetary and fiscal policies, the absence of which was so often the cause of earlier international financial crises. With increased emphasis on private international capital flows, especially interbank flows, private misjudgments within flawed economic structures have been the major contributors to recent problems. But inappropriate macroeconomic policies also have been a factor for some emerging market economies. We may be in a rapidly evolving international financial system with all the bells and whistles of the so-called new economy. But the old economy rules of prudence are as formidable as ever. We violate them at our own peril.