Alan Greenspan: Economic flexibility

Remarks by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the National Italian American Foundation, Washington DC, 12 October 2005.

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It is a pleasure once again to speak before the National Italian American Foundation. I have long since been awarded the status of honorary Italian, for which I am sincerely appreciative.

In my more than eighteen years at the Federal Reserve, much has surprised me, but nothing more than the remarkable ability of our economy to absorb and recover from the shocks of stock market crashes, credit crunches, terrorism, and hurricanes--blows that would have almost certainly precipitated deep recessions in decades past. This resilience, not evident except in retrospect, owes to a remarkable increase in economic flexibility, partly the consequence of deliberate economic policy and partly the consequence of innovations in information technology.

A couple of weeks ago, I outlined to a convention of fellow economists how I believe this all came about. I should like to share some of those views with you this morning.

For this country's first century and a half, government was only peripherally engaged in what we currently term the management of aggregate demand. Any endeavor to alter the path of private economic activity through active intervention would have been deemed inappropriate and, more important, unnecessary. In one of the more notable coincidences of history, our Declaration of Independence was signed the same year in which Adam Smith published his *Wealth of Nations*. Smith's prescription of letting markets prevail with minimal governmental interference became the guiding philosophy of American leadership for much of our history.

With a masterful insight into the workings of the free-market institutions that were then emerging, Smith postulated an "invisible hand" in which competitive behavior drove an economy's resources toward their fullest and most efficient use. Economic growth and prosperity, he argued, would emerge if governments stood aside and allowed markets to work.

Indeed, within a very few decades, free-market capitalism became the prevailing stance of most governments' economic policy, even if it was often implemented imperfectly. This framework withstood the conceptual onslaughts of Robert Owen's utopians, Karl Marx's communists and later, the Fabian socialists.

The free-market paradigm came under more-vigorous attack after the collapse of the world's major economies in the 1930s. As the global depression deepened, the seeming failure of competitive markets to restore full employment perplexed economists until John Maynard Keynes offered an explanation that was to influence policy practitioners for generations to come. He argued that, contrary to the tenets of Smith and his followers, market systems did not always converge to full employment. They often appeared to settle at an equilibrium in which significant segments of the workforce were unable to find jobs. In the place of Smith's laissez-faire approach arose the view that government action was required to restore full employment and to rectify what were seen as other deficiencies of market-driven outcomes.

A tidal wave of regulation soon swept over much of the American business community. Labor relations, securities markets, banking, agricultural pricing, and many other segments of the U.S. economy became subject to the oversight of government.

The apparent success of the economy during World War II, which operated at full employment in contrast to the earlier frightening developments during the Depression years, led to a considerable reluctance to fully dismantle wartime regulations when the hostilities came to an end.

However, cracks in the facade of government economic management appeared early in the post-World War II years, and those cracks continued to widen as time passed. At the macro level, the system of wage and price controls imposed in the 1970s to deal with the problem of inflation proved unworkable and ineffective. And at the micro level, heavy regulation of many industries was increasingly seen as impeding efficiency and competitiveness. By the early 1980s, the long-prevalent notion that the centrally planned economy of the Soviet Union was catching up with the West had begun to be discredited, though it was not fully discarded until the collapse of the Berlin Wall in 1989 exposed the economic ruin behind the Iron Curtain.

Starting in the 1970s, U.S. Presidents, supported by bipartisan majorities in the Congress, responded to the growing recognition of the distortions created by regulation, by deregulating large segments of the transportation, communications, energy, and financial services industries. The stated purpose of this deregulation was to enhance competition, which had come to be seen as a significant spur to productivity growth and elevated standards of living. Assisting in the dismantling of economic restraints was the persistent, albeit slow, lowering of barriers to cross-border trade and finance.

As a consequence, the United States, then widely seen as a once-great economic power that had lost its way, gradually moved back to the forefront of what Joseph Schumpeter, the renowned Harvard professor, had called "creative destruction"--the continual scrapping of old technologies to make way for the innovative. In that paradigm, standards of living rise because depreciation and other cash flows of industries employing older, increasingly obsolescent technologies are marshaled, along with new savings, to finance the production of capital assets that almost always embody cutting-edge technologies. Workers, of necessity, migrate with the capital.

Through this process, wealth is created, incremental step by incremental step, as high levels of productivity associated with innovative technologies displace less-efficient productive capacity. The model presupposes the continuous churning of a flexible competitive economy in which the new displaces the old.

As the 1980s progressed, the success of that strategy confirmed the earlier views that a loosening of regulatory restraint on business would improve the flexibility of our economy. No specific program encompassed and coordinated initiatives to enhance flexibility, but there was a growing recognition that a market economy could best withstand and recover from shocks when provided maximum flexibility.

Beyond deregulation, innovative technologies, especially information technologies, have contributed critically to enhanced flexibility. A quarter-century ago, for example, companies often required weeks to discover the emergence of inventory imbalances, allowing production to continue to exacerbate the excess. Excessive stockbuilding, in turn, necessitated a deeper decline in output than would have been necessary had the knowledge of the status of inventories been fully current. The advent of innovative information technologies significantly shortened the reporting lag, enabling flexible real-time responses to emerging imbalances.

Deregulation and the newer information technologies have joined, in the United States and elsewhere, to advance flexibility in the financial sector. Financial stability may turn out to have been the most important contributor to the evident significant gains in economic stability over the past two decades.

Historically, banks have been at the forefront of financial intermediation, in part because their ability to leverage offers an efficient source of funding. But in periods of severe financial stress, such leverage too often brought down banking institutions and, in some cases, precipitated financial crises that led to recession or worse. But recent regulatory reform, coupled with innovative technologies, has stimulated the development of financial products, such as asset-backed securities, collateral loan obligations, and credit default swaps, that facilitate the dispersion of risk.

Conceptual advances in pricing options and other complex financial products, along with improvements in computer and telecommunications technologies, have significantly lowered the costs of, and expanded the opportunities for, hedging risks that were not readily deflected in earlier decades. The new instruments of risk dispersal have enabled the largest and most sophisticated banks, in their credit-granting role, to divest themselves of much credit risk by passing it to institutions with far less leverage. Insurance companies, especially those in reinsurance, pension funds, and hedge funds continue to be willing, at a price, to supply credit protection.

These increasingly complex financial instruments have contributed to the development of a far more flexible, efficient, and hence resilient financial system than the one that existed just a quarter-century ago. After the bursting of the stock market bubble in 2000, unlike previous periods following large financial shocks, no major financial institution defaulted, and the economy held up far better than many had anticipated.

If we have attained a degree of flexibility that can mitigate most significant shocks--a proposition as yet not fully tested--the performance of the economy will be improved and the job of macroeconomic policymakers will be made much simpler.

Governments today, although still far more activist than in the nineteenth and early twentieth centuries, are rediscovering the benefits of competition and the resilience to economic shocks that it fosters. We are also beginning to recognize an international version of Smith's invisible hand in the globalization of economic forces.

Whether by intention or by happenstance, many, if not most, governments in recent decades have been relying more and more on the forces of the marketplace and reducing their intervention in market outcomes. We appear to be revisiting Adam Smith's notion that the more flexible an economy, the greater its ability to self-correct after inevitable, often unanticipated disturbances. That greater tendency toward self-correction has made the cyclical stability of the economy less dependent on the actions of macroeconomic policymakers, whose responses often have come too late or have been misguided.

It is important to remember that most adjustment of a market imbalance is well under way before the imbalance becomes widely identified as a problem. Individual prices, exchange rates, and interest rates, adjust incrementally in real time to restore balance. In contrast, administrative or policy actions that await clear evidence of imbalance are of necessity late.

Being able to rely on markets to do the heavy lifting of adjustment is an exceptionally valuable policy asset. The impressive performance of the U.S. economy over the past couple of decades, despite shocks that in the past would have surely produced marked economic contraction, offers the clearest evidence of the benefits of increased market flexibility.

We weathered a decline on October 19, 1987, of a fifth of the market value of U.S. equities with little evidence of subsequent macroeconomic stress--an episode that hinted at a change in adjustment dynamics. The credit crunch of the early 1990s and the bursting of the stock market bubble in 2000 were absorbed with the shallowest recessions in the post-World War II period. And the economic fallout from the tragic events of September 11, 2001, was moderated by market forces, with severe economic weakness evident for only a few weeks. Most recently, the flexibility of our market-driven economy has allowed us, thus far, to weather reasonably well the steep rise in spot and futures prices for oil and natural gas that we have experienced over the past two years. The consequence has been a far more stable economy.

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Flexibility is most readily achieved by fostering an environment of maximum competition. A key element in creating this environment is flexible labor markets. Many working people, regrettably, equate labor market flexibility with job insecurity.

Despite that perception, flexible labor policies appear to *promote* job creation, not destroy it. An increased capacity of management to discharge workers without excessive cost, for example, apparently increases companies' willingness to hire without fear of unremediable mistakes. The net effect, to the surprise of most, has been what appears to be a *decline* in the structural unemployment rate in the United States.

Protectionism in all its guises, both domestic and international, does not contribute to the welfare of American workers. At best, it is a short-term fix at a cost of lower standards of living for the nation as a whole. We need increased education and training for those displaced by creative destruction, not a stifling of competition.

A consequence of our highly competitive, rapidly growing economy is that the average American will hold many different jobs in a lifetime. Accordingly, education is no longer the sole province of the young. Significant numbers of workers continue their education well beyond their twenties. Millions enroll in community colleges in later life, for example, to upgrade their skills or get new ones. It is a measure of the dynamism of the U.S. economy that community colleges are one of the fastest growing segments of our educational system.

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Moving forward, I trust that we have learned durable lessons about the benefits of fostering and preserving a flexible economy. That flexibility has been the product of the economic dynamism of our workers and firms that was unleashed, in part, by the efforts of policymakers to remove rigidities and promote competition.

Although the business cycle has not disappeared, flexibility has made the economy more resilient to shocks and more stable overall during the past couple of decades. To be sure, that stability, by fostering speculative excesses, has created some new challenges for policymakers. But more fundamentally, an environment of greater economic stability has been key to the impressive growth in the standards of living and economic welfare so evident in the United States.

Y V Reddy: Banks and corporates as partners in progress

Valedictory address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the FICCI-IBA Conference on 'Global Banking: Paradigm Shift', Mumbai, 7 October 2005.

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Friends,

I am thankful to the organisers for giving me the opportunity to be with you and deliver the valedictory address at the FICCI-IBA Conference on 'Global Banking : Paradigm Shift'. It is noteworthy that eminent persons from diverse areas of expertise and experience have participated in the Conference; and quite a few of them are from global bodies such as, BIS and central bankers or banking regulators from Mauritius, Pakistan, Saudi Arabia, Singapore, U.K. and U.S.A. It is difficult to add significantly to the erudite discussions that have already taken place. I am well aware that I will be disappointing some analysts here by not giving my views on the macro-economic front and policy leads. This is a conscious choice as the formal announcement of the Mid-Term Review of the Annual Policy is due in about a couple of weeks. Any meaningful statement by me on monetary policy would militate against the emergence of a collegiate approach to monetary policy which is our avowed objective.

I had some difficulty in choosing a subject for this address since the three Deputy Governors and one Executive Director of the Reserve Bank India (RBI) have spoken at this Conference on almost all the relevant aspects and I also happen to fully agree with them. But the uniqueness of this Conference, in being sponsored by a Chamber of commerce and industry, and the banks' association, warrants some deliberation. Perhaps, it would be appropriate to dwell on certain aspects of how the banks and the corporates can nurture and strengthen their mutually rewarding partnership while also contributing to the progress of our economy.

At the outset, let me briefly recount the strengths of our banks and our corporates, as also the challenges faced by them. The performance of and outlook for the banking sector in India, as evidenced by the movement in Bankex relative to BSE Sensex in the recent years, appear to be positive. Both, the public and the private sector banks have gained in their equity prices and market capitalisation. The interest of Foreign Institutional Investors in the Indian banking sector is considerable and it is widely believed that their exposure to this sector is at the top, amounting to about one-sixth of their total exposure to India. The study of 'India's Top 20 Banks' by the S&P/ CRISIL, released this week, documents the steady improvement as well as their operating resilience and preparedness for Basel II. The Report lists the challenges, the most important being the risk-management and consolidation. RBI expects to release the Report on Trends and Progress in Banking in a couple of months, which, I hope, will add further comfort to the analysts of our banking sector.

Indian corporates have demonstrated that some of them are world-class with noticeable overseas acquisitions; and the global as well as domestic expectations from their entrepreneurship are perhaps unprecedented. S&P / CRISIL have also published a report on "Indian Top 50 Corporates" this week, which is candid in assessing the strengths of India's corporate sector along with possible challenges. As a central banker, I was struck by a remark in the Introduction to the Report. The Report appreciates the overall financial profiles of the top 50 corporates and describes them as currently 'strong' to 'adequate' but comments that the companies choosing to debt-finance their growth could face challenges. It is in this context that the joint efforts of the banks and the corporates in India could perhaps be an imperative for meeting the challenges ahead.

The relationship of the banker and corporate borrower in India has come a long way from the days of highly regulated economy. During the last two decades, there has been a sea change in the outlook of the banks as well as the corporates towards each other. While the balance sheets of banks are now stronger and their operations far more transparent, their lending practices too are better attuned to the requirements of various categories of borrowers. The corporates, on their part, have shown a greater sense of responsibility in the use and repayment of the borrowed funds. A noteworthy aspect is that under current guidelines relating to External Commercial Borrowings, Indian corporates have been able to borrow significant amounts from overseas directly, based on their own credit standing.

In this context, it would be useful to recall some of the important policy initiatives of the RBI relevant to bank-corporate relationship. Dr. Rangarajan's monetary policy of April 1997 announced a package of measures permitting multiple banking arrangements for the corporates and providing greater operational freedom to the banks. Dr. Jalan's policy pronouncements followed through this initiative with development of the money market, move towards universal banking and above all, urging the banks and corporates to put in place sound risk-management systems – particularly for market risks. In 2003, RBI issued a Fair Practices Code to be followed by the banks which aimed at making them more responsive to the borrowers and enhancing the confidence of borrowers in the banks as a source of funds. The procedure for declaring borrowers as "wilful defaulters" has been streamlined so as to afford full opportunity to the corporates to present their viewpoint before so classifying them.

Recent developments that warrant a careful redesign of the bank-corporate relationship include financing by multiple banks, through several instruments including investments, and access to a wider choice of sources of finance for corporates such as capital markets and external financing. Since such choices nudge towards transaction-based banker-customer relationship, these could impinge on the access to the information required by the bankers for financial assessment as also on the ability of corporates to get an assured and appropriately priced financial package. Perhaps there is a need for supplementing transaction-based relationship between banks and corporates with a more active and meaningful dialogue between them. I am sure such meetings do take place even now, but it is worth exploring whether the process needs to be strengthened. In this regard, there may be an advantage in industry bodies like FICCI and IBA embarking upon a review of the existing practices of dialogues between the banks and their corporate borrowers to ensure and enhance trust, transparency and timeliness – the three "t"s of banking. Such a review could perhaps also promote healthy competition amongst banks and add to the comfort of the corporates too.

The Corporate Debt Restructuring Mechanism (CDRM), which became operational since March 2002, is another platform for banker-corporate interface. Its efficacy is evident in the fact that well over one hundred cases have been approved for restructuring under this system. The CDRM was reviewed recently by a Special Group and we expect to bring out, in a couple of weeks, the revised operational guidelines for improvements in the CDRM to make the restructuring smoother for genuine cases.

Another area of common interest to the banks and the corporates is the risk management. The lenders and investors have an obvious interest in accurately assessing a firm's risk-management performance, apart from its underlying financials, so as to understand the risks assumed by the firm and those it has hedged or transferred to others. While the banks' risk exposures and their risk-management strategy is usually an item of public disclosure, there is a corresponding need for corporates too to make adequate disclosures regarding their risk exposures, specially to derivatives and foreign exchange. This would enable the banker to assess the risk profile of the corporate accurately and to evaluate the appropriateness of various financial products on offer. While these disclosures could be made mandatory through the Accounting Standards – on which, I understand, ICAI is working – it would be desirable if the corporates adopt such disclosures voluntarily, sooner than later, in their own as well as the system's interest.

It is useful for the bankers to track the changing dynamics of the pattern of corporate financing. The equity base of the corporate sector, relative to debt, seems to have increased, and many corporates are currently cash surplus, presumably to meet their investment commitments. Besides, the corporates also have access to other funding sources, especially external commercial borrowings and domestic and global capital markets. The Development Finance Institutions have substantially got subsumed in the banking sector and banks are increasingly functioning as universal banks. Banks' lending to households, be it through consumer credit or housing loans, has been increasing in the recent past along with increases in lending to priority sectors. It may, therefore, be worthwhile for banks, especially those with long history, to review their systems and procedures for lending and extending other forms of support to the corporates. An area of concern, in terms of public perception, is that there is under-pricing of credit risk for private sector corporates while there could be overpricing of risks in lending to agriculture as well as small and medium enterprises. There is merit in reviewing the current procedures and processes of pricing of credit, perhaps through a well structured segment-wise analysis of costs at various stages of intermediation in the whole credit cycle.

We also notice that several corporates are active in treasury management. Hence, they need to be well-equipped to identify, measure, manage and control the risks especially when, often, they are counterparties to the treasury transactions of the banks.

Regulatory framework for banks is gradually encouraging banks to assess and manage the risks on their own while regulation focuses on the adequacy and robustness of the systems in vogue in the banks for the purpose. The share of corporates in the lending by the banks, however, does not reflect the full range of the banks' exposure to them as it does not capture significant exposure to corporates through investments in bonds and other instruments. More important, banks' overall exposure would also include the non-funded exposures through credit substitutes and derivatives transactions which have grown significantly over the last few years. The continuing close linkage between the balance sheet of banks and of the corporate sector is, thus, clearly evident but only the nature of bank-corporate interaction is getting diverse and wider. A regulator's comfort, therefore, lies not only in satisfaction about the quality of risk-management in the banks but also in the banks' level of understanding of risk-management by their corporate clients. In a sense, there is an element of delegated supervision to be exercised by the banks over the corporates. In this background, a closer ongoing dialogue across a wider spectrum in a spirit of partnership between the banks and the corporates adds to the comfort of the regulator.

Consistent with the theme of the conference, it is essential to ponder over the implications of the paradigm shift in global banking for the bank-corporate relationship. There are differences across countries in the role and functioning of banks vis-à-vis the corporates. For example, the Anglo-Saxon, the European and the Japanese practices do vary though there is some evidence of elements of convergence with the emerging importance of trans-national corporates, global banks as well as financial intermediaries and increasing global financial integration. In the bank-dominated financial systems, such as in India, banks support corporates not only by direct lending, but also through their positions in money, debt, equity and derivatives markets. Further, the industrial progress involves entrepreneurship, inevitably entailing some measurement and management of implicit risks. As the partners in progress, the banks are now called upon not only to manage the risks in lending but increasingly, to also assess the risks involved in the business to which they are lending. In this background, the case for a more intense dialogue, to the extent of some partnering, becomes stronger.

Let me conclude by complimenting the organisers for the excellent Conference; the participants who met me deeply appreciated the high quality deliberations at this truly global gathering.

Thank you.