Norman T L Chan: 3Ds – an era of awakening?

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Good afternoon ladies and gentlemen,

I am honoured to receive the invitation to attend and speak at the 4th Santander International Banking Conference today.

It is only a few short years ago that the world economy was shaken to its core by the Global Financial Crisis. That we again face the threat of profound and traumatic disruption so soon is a measure of the urgency that governments must employ to correct the structural imbalances necessary to get the economy back on song for the long term.

Today I want to take up a little bit of your time explaining what I see as fundamental to righting the ship so that it can survive in the roughest of seas.

Collapse of Bretton Woods System

After World War II, the World's Superpowers tried to maintain a system of semi (or quasi) Gold Standard in which major currencies were fixed to the US dollar, which was in turn fixed to Gold at US$35 an ounce. This global monetary system was basically a fixed rate regime, which imposed an external discipline to restrain monetary expansion globally.

The Bretton Woods System became unsustainable as the US began to allow money supply to grow well beyond the gold reserves held by the US Government. When the System collapsed in 1972, the world's monetary system was converted to a fiat money regime in which major international currencies freely floated against each other. The post-Bretton Woods era represented a new era in which governments would be given more or less a free hand to pursue their national interests and domestic policy agenda without the rigid constraints imposed by a Gold Exchange Standard. Unfortunately, the initial experience under the new regime was far from satisfactory.

In my view, financial and macroeconomic stability cannot exist without an effective monetary anchor. For many centuries, the linkage to the precious metals had provided an external monetary anchor. Of course, the Gold Standard or Silver Standard had many shortcomings but it nevertheless provided an externally imposed discipline against monetary expansion. However, under the fiat money and floating rate regime, financial and macroeconomic stability can only be achieved if we have "3 Ds"! What does "3Ds" stand for? The first D stands for "Monetary Discipline", the second "Fiscal Discipline" and the third "Market Discipline". Conceptually, the removal of the external monetary anchor in the form of backing by precious metals must be replaced by these three types of discipline. If any of these three disciplines breaks down, then serious consequences or even a financial crisis may occur. Let me address these three disciplines in turn.

Monetary discipline

Unlike a fixed rate regime in which a national government can only issue currency if it can provide the backing (such as gold reserves), a floating rate regime allows national authorities to issue currency freely to suit their domestic needs. As we know, national central banks play a crucial role in controlling or influencing the supply of money. By changing interest rates or the price of money, central banks indirectly influence the expansion of credit and thus money

supply. Good monetary discipline is clearly needed to ensure that money or credit expansion does not become out of control. The initial experience in the US with the fiat money regime was not at all successful or pleasant. There was runaway inflation, rising from 5.8% in 1970 to 11.2% in 1979, and, as a result, Paul Volcker of the Fed had to introduce drastic measures to combat inflation by pushing interest rates to as high as 19%. It is now widely accepted that the breakdown of monetary discipline will lead to financial chaos with huge shocks to macroeconomic and financial stability.

After the recent Global Financial Crisis, we have come to realise how important it is to maintain the appropriate monetary discipline. It has been argued by many economists that one of the contributing factors leading to the Crisis was that the US policy interest rate was set too low for a prolonged period, which further fuelled credit growth and the housing bubble in the US. Of course financial innovation and the creation of highly opaque and leveraged financial derivative products, such as CDOs, also helped amplify the severity of the problem and transmit the shockwaves across the global financial system. The result: the global financial system nearly collapsed.

Fiscal discipline

More often than not monetary discipline breaks down because of the lack of fiscal discipline. One major reason why the US had to abandon the Bretton Woods system was the huge fiscal burden of financing the war in Vietnam, which also led to a sharp deterioration of the current account position of the US. There have been many examples of Government spending beyond their means resulting in the piling up of government or public debt. In the case of Argentina, the lack of fiscal discipline eventually brought down the Currency Board System that had served as an anchor of monetary stability for Argentina since 1991. In the case of Europe, the sovereign debt crisis that we are seeing now has been the consequence of a breakdown of the fiscal prudence and discipline over many years. Very few people would now doubt that macroeconomic and financial stability could be achieved in the longer run in the absence of fiscal discipline.

Market discipline

This is probably the most complex if not intriguing dimension of the three disciplines needed to maintain financial and macroeconomic stability. Traditionally, we all believe that market forces would be the last guard when national authorities failed to exercise monetary or fiscal discipline or both. In theory, the market should respond to a breakdown in monetary or fiscal discipline by demanding higher risk premium for the sovereign debt issued by those countries that are not behaving in a prudent manner. However, market discipline also seems to have broken down in many instances. For example, right after Greece joined the Euro Zone, the market was somehow attracted by the so called convergence play and for 8 years from 2001–2008 it ignored the fundamentals of Greece and its Single A rating and traded Greek sovereign debts as a Triple A credit, with a spread of as low as 8 basis points above German Bunds in February 2005. Looking back, the rationale for this kind of convergence play defies common sense and any analysis of fundamentals. However, the breakdown of the market discipline had played a key role in encouraging and facilitating continued erosion of fiscal discipline of the national authorities by conveying the wrong signals about the market tolerance, and appetite for their sovereign debts. As an illustration, the sharp fall of interest cost (10-year government bond yield) from over 10% in the mid 1990s to a low of 3% in the mid-2000s had also helped lower the cost of Greek Government borrowings and created the illusion of the affordability and sustainability of the rising pile of government debts.

There are many reasons why market forces are failing to impose discipline when national authorities or firms fail to behave prudently. However, it is fair to say that financial innovation in the last decade or so contributed in no small part to the breakdown of market discipline.

Coming back to the US, the proliferation of MBS and complex financial derivatives of CDOs had, as we now know, greatly increased the leverage and thus risk of the entire financial system. What was worse was that the structure of these financial products was so complex and so far removed from the underlying assets that it was virtually impossible for anyone, including the rating agencies, to fully understand the risks involved and to price such risks appropriately. We now know that there were thousands and thousands of CDOs sold before the Global Financial Crisis that were given Triple-A ratings simply because seriously flawed assumptions and models were used in assessing the risk of defaults. As I mentioned earlier, these financial derivatives had helped amplify the shocks and transmit these shocks across the global financial system during the latest Global Financial Crisis.

An era of awakening?

While we have seen many instances where market discipline has broken down, it is hard to believe that market discipline will break down permanently. As Europe has recently found out, the market can suddenly awaken and begin to doubt the fiscal sustainability of some members of the Euro Zone. This belated awakening has so far created considerable dislocation to the banking system and capital markets. Once the market discipline begins to kick in, the national and Pan European authorities have little choice but to push forward a series of drastic, painful but necessary austerity measures to quickly achieve fiscal consolidation and to restore market confidence.

Another important issue we are facing is to what extent monetary policy could be effective in supporting and stimulating economic growth. In other words, it is by no means clear that excessive accommodative monetary policy would be effective in boosting demand and creating jobs in the US and elsewhere and whether such policy, if deployed for a long period of time, would have undesirable consequences, both overseas and domestically, that would outweigh the likely benefits it could potentially generate.

I would argue that we central bankers must be able to recognise the pitfalls of trying to achieve goals that are beyond our reach. And I would agree with Chairman Bernanke when he said in his recent speech at the Jackson Hole conference that "most of the economic policies that support robust economic growth in the long run are outside the province of the central bank". While monetary discipline, fiscal discipline and market discipline are absolutely necessary conditions for economic stability and prosperity, they are clearly not sufficient conditions. For the global economy to recover and to return to its long-term growth trend, important structural imbalances in the major advanced economies have to be corrected. We must recognise that economic growth and prosperity built on excessive debts by households, corporates and the Governments are clearly not sustainable. We must awaken to the cruel reality that somehow the debt overhang accumulated over the years has to be reduced and redressed before consumers and investors can regain confidence on a brighter future.

To some of you my speech today may have sounded rather gloomy. You might have felt that it is easy for someone from Asia, a region that is growing strongly and to some extent suffering from overheating pressures, to lecture colleagues in Europe, which is in the midst of a sovereign debt crisis and suffering from low growth and high unemployment, about what are the right things to do. But it is far too easy to overlook the fact that Emerging Asia's dynamism today is the result of very painful adjustments that took place after the widespread devastation caused by the Asian Financial Crisis of 1997–98. You may or may not know that Hong Kong had had a very serious housing market bubble, which collapsed in late 1997. In the six years after that, housing prices declined by close to 70%, with unemployment rising three times. At the same time, the economy contracted by 8.7% over 5 quarters with deflation amounting to 15% during this period of adjustment. There was a lot of pain and sense of gloom during this very difficult period, but Hong Kong people did not give up and kept on trying their best to deal with the problems. After this very painful adjustment, Hong Kong has re-emerged stronger and more resilient than ever before.

In conclusion, I wish to leave with you the following message: the breakdown of monetary, fiscal and market disciplines has contributed to the deepness and severity of the latest crisis in the advanced economies. In my view, there is unfortunately no easy way out or clever solution that could avoid the need and thus the pain of structural adjustments that would redress the imbalances built up in the last decade or two. Going forward, we must realise that we have to restore the 3Ds or three Disciplines, without which the conditions for sustainable economic recovery would not exist. Are we now in an era of awakening? I am not totally sure but I think, or at least I hope, we are. If not, then market forces would eventually push all of us into that position, except that the later the awakening occurs the heavier the price we will have to pay.