Mr. Greenspan's testimony before the House of Respresentatives' Commmittee on Banking and Financial Services Testimony of the Chairman of the Governing Board of the US Federal Reserve System, Mr. Alan Greenspan, before the Committee on Banking and Financial Services of the US House of Representatives in Washington DC, on 13/11/97.

Recent developments in world finance have highlighted growing interactions among national financial markets. The underlying technology-based structure of the international financial system has enabled us to improve materially the efficiency of the flows of capital and payment systems. That improvement, however, has also enhanced the ability of the financial system to transmit problems in one part of the globe to another quite rapidly. Doubtless, there is much to be learned from the recent experience in Asia that can be applied to better the workings of the international financial system and its support of international trade that has done so much to enhance living standards worldwide.

While each of the Asian economies differs in many important respects, the sources of their spectacular growth in recent years, in some cases decades, and the problems that have emerged are relevant to a greater or lesser extent to nearly all of them.

Following the early post-World War II period, policies generally fostering low levels of inflation and openness of their economies coupled with high savings and investment rates contributed to a sustained period of rapid growth, in some cases starting in 1960s and 1970s. By the 1980s most economies in the region were expanding vigorously. Foreign net capital inflows grew, but until recent years were relatively modest. The World Bank estimates that net inflows of long-term debt, foreign direct investment, and equity purchases to the Asia Pacific region were only about $25 billion in 1990, but exploded to more than $110 billion by 1996.

A major impetus behind this rapid expansion was the global stock market boom of the 1990s. As that boom progressed, investors in many industrial countries found themselves more heavily concentrated in the recently higher valued securities of companies in the developed world, whose rates of return, in many instances, had fallen to levels perceived as uncompetitive with the earnings potential in emerging economies, especially in Asia. The resultant diversification induced a sharp increase in capital flows into those economies. To a large extent, they came from investors in the United States and Western Europe. A substantial amount came from Japan, as well, owing more to a search for higher yields than to rising stock prices and capital gains in that country. The rising yen through mid-1995 also encouraged a substantial increase in direct investment inflows from Japan. In retrospect, it is clear that more investment monies flowed into these economies than could be profitably employed at modest risk.

I suspect that it was inevitable in those conditions of low inflation, rapid growth, and ample liquidity that much investment moved into the real estate sector, with an emphasis by both the public and private sectors on conspicuous construction projects. This is an experience, of course, not unknown in the United States on occasion. These real estate assets, in turn, ended up as collateral for a significant proportion of the assets of domestic financial systems. In many instances, those financial systems were less than robust, beset with problems of lax lending standards, weak supervisory regimes, and inadequate capital.

Moreover, in most cases, the currencies of these economies were closely tied to the U.S. dollar, and the dollar's substantial recovery since mid-1995, especially relative to the yen, made their exports less competitive. In addition, in some cases, the glut of semiconductors in 1996 suppressed export growth, exerting further pressures on highly leveraged businesses.

However, overall GDP growth rates generally edged off only slightly, and imports, fostered by rising real exchange rates, continued to expand, contributing to what became unsustainable current account deficits in a number of these economies. Moreover, with exchange rates seeming to be solidly tied to the dollar, and with dollar and yen interest rates lower than domestic currency rates, a significant part of the enlarged capital inflows into these economies, in particular short-term flows, was denominated by the ultimate borrowers in foreign currencies. This put additional pressure on companies to earn foreign exchange through exports.

The pressures on fixed exchange rate regimes mounted as foreign investors slowed the pace of new capital inflows, and domestic businesses sought increasingly to convert domestic currencies into foreign currencies, or, equivalently, slowed the conversion of export earnings into domestic currencies. The shifts in perceived future investment risks led to sharp declines in stock markets across Asia, often on top of earlier declines or lackluster performances.

To date, the direct impact of these developments on the American economy has been modest, but it can be expected not to be negligible. U.S. exports to Thailand, the Philippines, Indonesia, and Malaysia (the four countries initially affected) were about 4 percent of total U.S. exports in 1996. However, an additional 12 percent went to Hong Kong, Korea, Singapore and Taiwan (economies that have been affected more recently). Thus, depending on the extent of the inevitable slowdown in growth in this area of the world, the growth of our exports will tend to be muted. Our direct foreign investment in, and foreign affiliate earnings reported from, the economies in this region as a whole have been a smaller share of the respective totals than their share of our exports. The share is, nonetheless, large enough to expect some drop-off in those earnings in the period ahead. In addition, there will be indirect effects on the U.S. real economy from countries such as Japan that compete even more extensively with the economies in the Asian region.

Particularly troublesome over the past several months has been the so-called contagion effect of weakness in one economy spreading to others as investors perceive, rightly or wrongly, similar vulnerabilities. Even economies, such as Hong Kong, with formidable stocks of international reserves, balanced external accounts, and relatively robust financial systems, have experienced severe pressures. One can debate whether the turbulence in Latin American asset values reflects contagion effects from Asia, the influence of developments in U.S. financial markets, or home-grown causes. Whatever the answer, and the answer may be all of the above, this phenomenon illustrates the interdependencies in today’s world economy and financial system.

Perhaps it was inevitable that the impressive and rapid growth experienced by the economies in the Asian region would run into a temporary slowdown or pause. But there is no reason that above-average growth in countries that are still in a position to gain from catching up with the prevailing technology cannot persist for a very long time. Nevertheless, rapidly developing, free-market economies periodically can be expected to run into difficulties because investment mistakes are inevitable in any dynamic economy. Private capital flows may temporarily turn adverse. In these circumstances, companies should be allowed to default, private investors should take their losses, and government policies should be directed toward laying the macroeconomic and structural foundations for renewed expansion; new growth opportunities must be allowed to emerge. Similarly, in providing any international financial assistance, we need to be mindful of the desirability of minimizing the impression that international authorities stand ready to guarantee the external liabilities of sovereign governments or failed domestic businesses. To do otherwise could lead to distorted investments and could ultimately unbalance the world financial system.

The recent experience in Asia underscores the importance of financially sound domestic banking and other associated financial institutions. While the current turmoil has significant interaction with the international financial system, the recent crises would arguably have been better contained if long-maturity property loans had not accentuated the usual mismatch between maturities of assets and liabilities of domestic financial systems that were far from robust to begin with. Our unlamented savings and loan crises come to mind.

These are trying days for economic policymakers in Asia. They must fend off domestic pressures that seek disengagement from the world trading and financial system. The authorities in these countries are working hard, in some cases with substantial assistance from the IMF, the World Bank, and the Asian Development Bank, to stabilize their financial systems and economies.

The financial disturbances that have afflicted a number of currencies in Asia do not at this point, as I indicated earlier, threaten prosperity in this country, but we need to work closely with their leaders and the international financial community to assure that their situations stabilize. It is in the interest of the United States and other nations around the world to encourage appropriate policy adjustments, and where required, provide temporary financial assistance.