Mr. Greenspan analyses further the roots of the current crisis in Asia

Testimony by the Chairman of the Board of the US Federal Reserve System, Mr. Alan Greenspan, before the Committee on Banking and Financial Services of the US House of Representatives on 30/1/98.

The global financial system has been evolving rapidly in recent years. New technology has radically reduced the costs of borrowing and lending across traditional national borders, facilitating the development of new instruments and drawing in new players. One result has been a massive increase in capital flows. Information is transmitted instantaneously around the world, and huge shifts in the supply and demand for funds naturally follow.

This burgeoning global system has been demonstrated to be a highly efficient structure that has significantly facilitated cross-border trade in goods and services and, accordingly, has made a substantial contribution to standards of living worldwide. Its efficiency exposes and punishes underlying economic weakness swiftly and decisively. Regrettably, it also appears to have facilitated the transmission of financial disturbances far more effectively than ever before.

As I testified before this Committee three years ago, the then emerging Mexican crisis was the first such episode associated with our new high-tech international financial system. The current Asian crisis is the second.

We do not as yet fully understand the new system's dynamics. We are learning fast, and need to update and modify our institutions and practices to reduce the risks inherent in the new regime. Meanwhile, we have to confront the current crisis with the institutions and techniques we have.

Many argue that the current crisis should be allowed to run its course without support from the International Monetary Fund or the bilateral financial backing of other nations. They assert that allowing this crisis to play out, while doubtless having additional negative effects on growth in Asia, and engendering greater spill-overs onto the rest of the world, is not likely to have a large or lasting impact on the United States and the world economy.

They may well be correct in their judgment. There is, however, a small but not negligible probability that the upset in East Asia could have unexpectedly negative effects on Japan, Latin America, and eastern and central Europe that, in turn, could have repercussions elsewhere, including the United States. Thus, while the probability of such an outcome may be small, its consequences, in my judgment, should not be left solely to chance. We have observed that global financial markets, as currently organized, do not always achieve an appropriate equilibrium, or at least require time to stabilize.

Opponents of IMF support also argue that the substantial financial backing, by cushioning the losses of imprudent investors, could exacerbate moral hazard. Moral hazard arises when someone can reap the rewards from their actions when things go well but do not suffer the full consequences when things go badly. Such a reward structure, obviously, could encourage excessive risk taking. To be sure, this is a problem, though with respect to Asia some investors have to date suffered substantial losses. Asian equity losses, excluding Japan, since June 1997 worldwide are estimated to have exceeded $700 billion of which more than $30 billion has been lost by U.S. investors. Substantial further losses have been recorded in bonds and real estate.

Moreover, the policy conditionality, associated principally with IMF lending, which dictates economic and financial discipline and structural change, helps to mitigate some of the moral hazard concerns. Such conditionality is also critical to the success of the overall stabilization effort. As I will be discussing in a moment, at the root of the problems is poor public policy that has resulted in misguided investments and very weak financial sectors. Convincing a sovereign nation to alter destructive policies that impair its own performance and threaten contagion to its neighbors is best handled by an international financial institution, such as the IMF. What we have in place today to respond to crises should be supported even as we work to improve those mechanisms and institutions.

Accordingly, I fully back the Administration's request to augment the financial resources of the IMF -- U.S. participation in the New Arrangements to Borrow and an increase in the U.S. quota in the IMF. Hopefully, neither will turn out not to be needed, and no funds will be drawn. But it is better to have it available if that turns out not to be the case and quick response to a pending crisis is essential. I also believe it is important to have mechanisms, such as the Treasury Department's Exchange Stabilization Fund, that permit the United States in exceptional circumstances to provide temporary bilateral financial support, often on short notice, under appropriate conditions and on occasion in cooperation with other countries.

In my testimony before this Committee in mid-November, I endeavored to outline the roots of the current crisis. This morning I should like to carry the analysis a bit further.

Companies in Korea and many other Asian countries have become formidable world-class producers in a number of manufacturing sectors using advanced technologies, but in a number of cases they permitted leverage to rise to levels that could only be sustained with continued very rapid growth. Growth, however, was destined to slow.

Asian economies to varying degrees over the last half century have tried to combine rapid growth with a much higher mix of government-directed production than has been evident in the essentially market-driven economies of the West. Through government inducements, a number of select, more sophisticated manufacturing technologies borrowed from the advanced market economies were applied to these generally low-productivity and, hence, low-wage economies. Thus, for selected products, exports became competitive with those of the market economies, engendering rapid overall economic growth.

There was, however, an inevitable limit to how far this specialized Asian economic regime could develop. As the process broadened beyond a few select applications of advanced technologies, overall productivity continued to increase and the associated rise in the average real wage in these economies blunted somewhat the competitive advantage enjoyed initially. As a consequence of the slackening of export expansion caused in part by losses in competitiveness because of exchange rates that were pegged to the dollar, which was appreciating against the yen, aggregate economic growth slowed somewhat, even before the current crisis.

For years, domestic savings and rapidly increasing capital inflows had been directed by governments into investments that banks were required to finance. As I pointed out in previous testimony, lacking a true market test, much of that investment was unprofitable. So long as growth was vigorous, the adverse consequences of this type of non-market allocation of resources were masked. Moreover, in the context of pegged exchange rates that were presumed to continue, if not indefinitely, at least beyond the term of the loan, banks and nonbanks were willing to take the risk to borrow dollars (unhedged) to obtain the dollar-denominated interest rates that were invariably lower than those available in domestic currency. Western, especially American investors, diversified some of their huge capital gains of the 1990s into East Asian investments. In hindsight, it is evident that those economies could not provide adequate profitable opportunities at reasonable risk to absorb such a surge in funds. This surge, together with distortions caused by government planning, has resulted in huge losses. With the inevitable slowdown, business losses and nonperforming bank loans surged. Banks' capital eroded rapidly and, as a consequence, funding sources have dried up, as fears of defaults have risen dramatically. In an environment of weak financial systems, lax supervisory regimes, and vague guarantees about depositor or creditor protections, bank runs have occurred in several countries and reached crisis proportions in Indonesia. Uncertainty and retrenchment have escalated. The state of confidence so necessary to the functioning of any economy has been torn asunder. Vicious cycles of ever rising and reinforcing fears have become contagious. Some exchange rates have fallen to levels that are understandable only in the context of a veritable collapse of confidence in the functioning of an economy.

A similar breakdown was also evident in Mexico three years ago, albeit to a somewhat lesser degree. In late 1994, the government was rapidly losing reserves in a vain effort to support a currency that had come under attack when the authorities failed to act expeditiously and convincingly to contain a burgeoning current account deficit financed in large part by substantial short-term flows denominated in dollars.

These two recent crisis episodes have afforded us increasing insights into the dynamics of the evolving international financial system, though there is much we do not yet understand.

With the new more sophisticated financial markets punishing errant government policy behavior far more profoundly than in the past, vicious cycles are evidently emerging more often. For once they are triggered, damage control is difficult. Once the web of confidence, which supports the financial system, is breached, it is difficult to restore quickly. The loss of confidence can trigger rapid and disruptive changes in the pattern of finance, which, in turn, feeds back on exchange rates and asset prices. Moreover, investor concerns that weaknesses revealed in one economy may be present in others that are similarly situated means that the loss of confidence can quickly spread to other countries.

At one point the economic system appears stable, the next it behaves as though a dam has reached a breaking point, and water (read, confidence) evacuates its reservoir. The United States experienced such a sudden change with the decline in stock prices of more than 20 percent on October 19, 1987. There is no credible scenario that can readily explain so abrupt a change in the fundamentals of long-term valuation on that one day. Such market panic does not appear to reflect a simple continuum from the immediately previous period. The abrupt onset of such implosions suggests the possibility that there is a marked dividing line for confidence. When crossed, prices slip into free fall -- perhaps overshooting the long-term equilibrium -- before markets will stabilize.

But why do these events seem to erupt without some readily evident precursor? Certainly, the more extended the risk-taking, or more generally, the lower the discount factors applied to future outcomes, the more vulnerable are markets to a shock that abruptly triggers a revision in expectations and sets off a vicious cycle of contraction.

Episodes of vicious cycles cannot be easily forecast, as our recent experience with Asia has demonstrated. The causes of such episodes are complex and often subtle. In the case of

Asia, we can now say with some confidence that the economies affected by this crisis faced a critical mass of vulnerabilities; ex ante, some were more apparent than others, but the combination was not generally recognized as critical.

Once the recent crisis was triggered in early July with Thailand's forced abandonment of its exchange rate peg, it was apparently the lethal combination of pegged exchange rates, high leverage, weak banking and financial systems, and declining demand in Thailand and elsewhere that transformed a correction into a collapse. Normally the presence of these factors would have produced a modest retrenchment, not the kind of discontinuous fall in confidence that leads to a vicious cycle of decline. But with a significant part of short-term liabilities, bank and nonbank, denominated in foreign currencies (predominantly dollars), unhedged, the initial pressure on domestic currencies led to a sharp crack in the fixed exchange rate structure of many East Asian economies. The belief that local currencies could, virtually without risk of loss, be converted into dollars at any time was shattered. Investors, both domestic and foreign, endeavored en masse to convert to dollars, as confidence in the ability of the local economy to earn dollars to meet their fixed obligations diminished. Local exchange rates fell against the dollar, inducing still further declines.

The weakening of growth also led to lowered profit expectations and contracting net capital inflows of dollars. This was an abrupt change from the pronounced acceleration through 1996 and the first half of 1997. The combination of continued strong demand for dollars to meet debt service obligations and the slowed new supply, destabilized the previously fixed exchange rate regime. This created a marked increase in uncertainty and retrenchment, further reducing capital inflows, still further weakening local currency exchange rates. This vicious cycle will continue until either defaults or restructuring lowers debt service obligations, or the low local exchange rates finally induce a pickup in the supply of dollars.

These virulent episodes appear to be at the root of our most recent breakdowns in Mexico and Asia. Their increased prevalence may, in fact, be a defining characteristic of the new high-tech international financial system. We shall never be able to alter the human response to shocks of uncertainty and withdrawal; we can only endeavor to reduce the imbalances that exacerbate them.

While, as indicated earlier, I do not believe we are as yet sufficiently knowledgeable of the full complex dynamics of our increasingly developing high-tech financial system, enough insights have been gleaned from the crises in Mexico and Asia (and previous experiences) to enable us to list a few of the critical tendencies toward disequilibrium and vicious cycles that will have to be addressed if our new global economy is to limit the scope for disruptions in the future. These elements have all, in times past, been factors in international and domestic economic disruptions, but they appear more stark in today's market.

1. Leverage
   Certainly in Korea, probably in Thailand, and possibly elsewhere, a high degree of leverage (the ratio of debt to equity) appears to be a place to start. While the key role of debt in bank balance sheets is obvious, its role in the efficient functioning of the nonbank sector is also important. Nevertheless, exceptionally high leverage often is a symptom of excessive risk taking that leaves financial systems and economies vulnerable to loss of confidence. It is not easy to imagine the cumulative cascading of debt instruments seeking safety in a crisis when assets are heavily funded with equity. The concern is particularly relevant to banks and many other financial intermediaries, whose assets typically are less liquid than their liabilities and so depend on confidence in the payment of

liabilities for their continued viability. Moreover, both financial and nonfinancial businesses can employ high leverage to mask inadequate underlying profitability and otherwise have inadequate capital cushions to match their volatile environments.

Excess leverage in nonfinancial business can create problems for lenders including their banks; these problems can, in turn, spread to other borrowers that rely on these lenders. Fortunately, since lending by nonfinancial firms to other businesses is less prevalent than bank lending to other banks, direct contagion is less likely. But the leverage of South Korea’s chaebols, because of their size and the pervasive distress, has clearly been an important cause of bank problems with their systemic implications.

2. Interest rate and currency risk
   Banks, when confronted with a generally rising yield curve, have a tendency to incur interest rate or liquidity risk by lending long and funding short. This exposes them to shocks, especially those institutions that have low capital-asset ratios. When financial intermediaries, in addition, seek low-cost, unhedged, foreign currency funding, the dangers of depositor runs, following a fall in the domestic currency, escalate.

3. Weak banking systems
   Banks play a crucial role in the financial market infrastructure. When they are undercapitalized, have lax lending standards, and are subjected to weak supervision and regulation, they become a source of systemic risk both domestically and internationally.

4. Interbank funding, especially in foreign currencies
   Despite its importance for distributing savings to their most valued use, short-term interbank funding, especially cross border may turn out to be the Achilles’ heel of an international financial system that is subject to wide variations in financial confidence. This phenomenon, which is all too common in our domestic experience, may be particularly dangerous in an international setting.

5. Moral hazard
   The expectation that monetary authorities or international financial institutions will come to the rescue of failing financial systems and unsound investments has clearly engendered a significant element of moral hazard and excessive risk taking. The dividing line between public and private liabilities, too often, becomes blurred.

6. Weak central banks
   To effectively support a stable currency, central banks need to be independent, meaning that their monetary policy decisions are not subject to the dictates of political authorities.

7. Securities markets
   Recent adverse banking experiences have emphasized the problems that can arise if banks are almost the sole source of intermediation. Their breakdown induces a sharp weakening in economic growth. A wider range of nonbank institutions,

including viable debt and equity markets, are important safeguards of economic activity when banking fails.

8. Inadequate legal structures
   Finally, an effective competitive market system requires a rule of law that severely delimits government's arbitrary intrusion into commercial disputes.

   Defaults and restructuring will not always be avoidable. Indeed "creative destruction", as Joseph Schumpeter put it, is often an important element of renewal in a dynamic market economy, but an efficient bankruptcy statute is required to aid in this process, including in the case of cross-border defaults.

* * *

Interest and currency risk taking, excess leverage, weak financial systems, and interbank funding are all encouraged by the existence of a safety net. In a domestic context, it is difficult to achieve financial balance without a regulatory structure that seeks to simulate the market incentives that would tend to control these financial elements if there were not broad safety nets. It is even more difficult to achieve such a balance internationally among sovereign governments operating out of different cultures. Thus, governments have developed a patchwork of arrangements and conventions governing the functioning of the international financial system that I believe will need to be thoroughly reviewed and altered as necessary to fit the needs of the new global environment. A review of supervision and regulation of private financial institutions, especially those that are supported by a safety net, is particularly pressing because those institutions have played so prominent a role in the emergence of recent crises.

As I have testified previously, I believe that, in this rapidly expanding international financial system, the primary protection from adverse financial disturbances is effective counterparty surveillance and, hence, government regulation and supervision should seek to produce an environment in which counterparties can most effectively oversee the credit risks of potential transactions.

Here a major improvement in transparency, including both accounting and public disclosure, is essential. To be sure, counterparties often exchange otherwise confidential information as a condition of a transaction. But broader dissemination of detailed disclosures of governments, financial institutions, and firms, is required if the risks inherent in our global financial structure are to be contained. A market system can approach an appropriate equilibrium only if the signals to which individual market participants respond are accurate and adequate to the needs of the adjustment process. Among the important signals are product and asset prices, interest rates, debt by maturity, detailed accounts of central banks, and private enterprises. Blinded by faulty signals, a competitive free-market system cannot reach a firm balance except by chance. In today's rapidly changing market place producers need sophisticated signals to hone production schedules and investment programs to respond to consumer demand.

There is sufficient bias in political systems of all varieties to substitute hope (read, wishful thinking) for possibly difficult pre-emptive policy moves, both with respect to financial systems and economic policy. There is often denial and delay in instituting proper adjustments. Recent propensities to obscure the need for change have been evidenced by unreported declines in official reserves, issuance by governments of the equivalent to foreign currency obligations, or unreported large forward short positions against foreign currencies. It is very difficult for political leaders to incur what they perceive as large immediate political costs to contain problems that they see (often dimly) as only prospective.

Reality eventually replaces hope, but the cost of delay is a more abrupt and disruptive adjustment than would have been required if action had been more pre-emptive. Increased transparency for businesses, financial institutions, and governments is a key ingredient in fostering more discipline on private transactors and on government policymakers. Increased transparency can counter political bias in part by exposing for all to see the risks to stability of current policies as they develop. Under such conditions, failure to act would also be perceived as having political costs. I suspect that recent political foot dragging by governments in both developed and developing countries on the issue of greater transparency is credible evidence of its power and significance.

Transparency, which is so important to foster safe and sound lending practices, is, of course, less relevant for local currency lending if banks are guaranteed with sovereign credits. Moreover, transparency becomes especially difficult to create for organizations and corporations with large interlocking ownerships. Cross holdings of stock lead too often to lending on the basis of association, not economic value.

The list of problems that must be addressed to achieve balance in our future global financial system could be significantly extended, but let me end with a notion that is relevant also to today's crisis. It is becoming increasingly evident that supervision and regulation should address excess nonperforming loans expeditiously. The expected values of the losses on these loans are, of course, a subtraction from capital. But since these estimates are uncertain, they embody an additional risk premium that reduces the markets' best estimate of the size of effective equity capital even if capital is replenished. It is, hence, far better to remove these dubious assets and their associated risk premium from bank balance sheets, and dispose of them separately, preferably promptly.

* * *

As a consequence of the unwinding of market restrictions and regulations, and the rapid increase in technology, the international financial system has expanded at a pace far faster than either domestic GDP or cross-border trade. To reduce the risk of systemic crises in such an environment, an enhanced regime of market incentives, involving greater sensitivity to market signals, more information to make those signals more robust, and broader securities markets -- coupled with better supervision -- is essential. Obviously appropriate macro policies, as ever, are assumed. But attention to micro details is becoming increasingly pressing.

Nonetheless, it is reasonable to expect that despite endeavors at risk containment and prevention the system may fail in some instances, triggering vicious cycles and all the associated contagion for innocent bystanders. A backup source of international financial support provided only with agreed conditions to address underlying problems, the task assigned to the IMF, can play an essential stabilizing role. The availability of such support must be limited because its size cannot be expected to expand at the pace of the international financial system. I doubt if there will be worldwide political support for that.

In closing, I should like to stress that the significant degree of volatility that continues to exist in Asian markets indicates exceptionally high levels of uncertainty, bordering on panic. It is not reasonable to expect that the substantial investments needed to implement meaningful structural reforms can proceed very far until we observe a simmering down of frenetic changes in asset prices and exchange rates.

That is likely to result only when stability of banking and financial systems generally is achieved. As I indicated in my November testimony, the failure of the fragile banking systems of East Asia to hold steady as financial pressures increased was a defining element in the developing crisis. The stabilization of those banking systems is crucial, if confidence, that has been so thoroughly undercut in this most debilitating crisis, is to be restored.