Mr Crockett asks whether the international financial system needs mending

Speech by Mr Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the Financial Stability Forum, at the Friedrich-Ebert-Stiftung in Frankfurt on 8 December 1999.

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The collapse of the Bretton Woods system in the early 1970s marked an important turning point in the post-war evolution of the financial system. Until about that time, the international monetary system was a heavily managed and administered one, based on fixed exchange rates, regulated domestic markets and restrictions on the cross-border flow of financial capital. As these arrangements crumbled under the weight of widening payment imbalances and the growing internationalisation of finance, a market-led system emerged. The process of equilibrium-seeking and adjustment was progressively left to the forces of competition. Exchange rates were allowed to float, domestic financial intermediation was liberalised and capital accounts were gradually opened. Some labelled these new arrangements a "non-system" - although there is nothing inherently unsystematic about an economic system based on competitive forces and decentralised decision taking.

For the last quarter century or so, domestic as well as international financial arrangements have thus relied on increasingly open and integrated markets as the main engines of adjustment and stability. Spurred by the freedom to innovate, technological progress and the appeal of investment opportunities in an increasingly global economy, financial activity has expanded enormously. The role of the financial sector in mobilising and allocating resources, both within national economies and across geographic boundaries, has expanded commensurately. For the most part, an open international financial system has operated to the benefit of economic activity and wider social welfare. It has channelled savings to countries with productive investment opportunities, it has been a vehicle for the transfer of managerial and technological know-how, and it has served as a source of discipline on unsustainable and harmful macroeconomic policies. An open trading and financial environment enabled many Asian countries to lift their peoples out of poverty in the space of a single generation.

Recent years, however, have witnessed events that show the darker side of these market forces. A particularly virulent crisis enveloped several Asian economies in 1997. Only shortly thereafter, Russia and Brazil succumbed to financial turmoil. And even financial markets in the more mature economies took fright as the globalisation of markets allowed contagion to spread beyond the emerging market economies. The social costs, while not wiping out earlier gains, were severe.

Do these crises demonstrate that the post-Bretton Woods model of financial arrangements has outlasted its useful life? Do financial markets show an inherent and damaging instability which argues for a return to administrative control? Is now the time to consider a fundamental change in the way financial activity is organised, in the way it is monitored and managed, and in the way losses and gains are shared? Many indeed are calling for a "new financial architecture", though concrete proposals of what this new construction could look like have yet to be formulated.

My own view is that the basic components of today's system of financial intermediation continue to be the only reliable and efficient ones, but that the rough edges of the market-led system need better monitoring and in some cases repair. In other words, the architecture or design of the financial system – the basic rule of decentralised, market-led decision-making – remains sound, but its internal wiring and plumbing – the preconditions which ensure that markets can indeed operate efficiently and stably – may require upgrading.

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Which are the areas of vulnerability or failure which cause markets to display excessive instability, and lead to such severe costs? And why are financial markets particularly prone to such failures? At the risk of over simplification, I propose to focus on three sources of market failure which have been particularly prevalent in the recent episode of worldwide financial turbulence. They are: *first*, the lack of relevant information and its asymmetric distribution across market participants; *second*, the presence of externalities that can give rise to undesired and unintended market outcomes; and *third*, the difficulty of establishing an adequate infrastructure in financial markets. Note that I make hardly any distinction between the domestic and the international financial system. With the globalisation of finance and the lifting of controls, the two have basically merged. As I will argue, however, dealing with market failures at the international level may be much more complex than in a domestic setting.

Information and financial activity

Let me start with the first area of financial market vulnerability, that of information deficits. Financial activity is particularly information-intensive. More than any other sector perhaps, financial markets have to cope with a high degree of uncertainty. This is a reflection of the fact that by nature finance is an intertemporal activity: services to which counterparties commit themselves in financial contracts are delivered over sometimes very long periods during which circumstances can change in unforeseen ways. Moreover, with finance having become increasingly borderless, exposures have grown to counterparties and markets much less familiar than those at home. The global and the intertemporal character of financial intermediation therefore puts a premium on ensuring that clear and comprehensive information is at the disposal of market participants.

Yet such information is often not readily available. It may be expensive, or it may be distributed unevenly across market players. Not all participants are willing to bear the cost of collecting the necessary information, in particular when it is easy for others to free-ride on their efforts. Decisions may then be taken on the basis of a less-than-complete information set and risks may be run which in a more informed environment would have been avoided.

Another frequent occurrence in financial markets is that participants have unequal access to information. Borrowers typically are several steps ahead of lenders in knowing the probabilities of success of their projects and how gains and losses might be shared. Lenders may be unaware that the funds they provide flow to the most risky investments, or are wasted on less productive activities. To protect themselves against this information deficit, lenders may ration their finance or even withdraw from participation altogether. In the economic literature, these problems, known as adverse selection and moral hazard, have been shown to have a negative impact on financial market efficiency, especially in a cross-border setting.

The recent Asian crisis is a good example of how lending and borrowing decisions can be biased by lack or uneven distribution of information. Few investors realised to what extent the massive flow of foreign-currency funds into several Asian economies was diverted into activities with little or no prospects of generating foreign-currency resources, or, should the economy turn down, of yielding any returns at all. Confidence in official reserve data was greatly shaken as it became clear to what extent foreign exchange assets were mortgaged by massive short forward positions in Thailand or by placements in overseas branches of Korean banks facing problems themselves in meeting foreign currency obligations.

Moral hazard was also a problem. Given that they believed that their liabilities were implicitly guaranteed, Korean chaebol embarked on a largely unfettered investment spree. At the same time, domestic banks and foreign investors in South East Asian countries took unwarranted comfort from governments' commitments to maintain fixed exchange rates, or from expectations that the international community would help safeguard private investment. These expectations prolonged the period of excessive capital inflow; and thus rendered more costly its eventual reversal.

Market outcomes: the sum of its parts or somewhat less?

A second problem in financial markets is that the sum of individual decisions which on their own are perfectly rational may not always lead to a stable equilibrium or a socially desirable outcome. A sudden loss of confidence in one particular bank can sometimes lead to an indiscriminate run on the entire banking system. Similarly, evidence of an isolated foreign debt servicing problem can be magnified into a generalised "rush for the exits". The crisis which follows almost always seems to push the domestic currency beyond an equilibrium level with damaging social consequences. In both of these examples, attempts by individual agents to protect their financial positions generate externalities which precipitate the very consequence against which these actions are designed to guard.

Many other examples of similar problems of aggregation in financial markets can be given. Herd instinct is often identified as one of the main factors behind the surges in capital flows and their sudden shifts in recent years. Such herd behaviour may be rational in the context in which it occurs. Fear of under performance runs deep in the highly competitive financial industry and induces portfolio managers to mirror each other's investment strategies or to stick close to benchmarks. Often, too, attitudes are more lenient towards those who are wrong in good company, than to those making a wrong bet on their own. Whether understandable or not, herd behaviour nevertheless adds to an unacceptable degree of volatility in financial markets.

In the East Asian case, herd instinct undoubtedly played a part in the over-lending that preceded the crisis. Western banks and fund managers were fearful of being left behind in the rush to participate in the Asian "miracle". Then, when sentiment turned, investors wanted to reduce their exposure as rapidly as possible, fearing a currency and banking collapse that would threaten their investments. With limited reserves and borrowing possibilities, the countries in the region all saw their currencies overshoot. The succeeding interaction of banking and currency problems imposed costs out of all proportion to the original policy mistakes.

At times, these aggregation problems are in part self-inflicted. If short-term lending enjoys more favourable risk weights than longer-term credit exposures, as is the case in the 1988 Basel Capital Accord, creditors may want to shorten the maturity of their cross-border claims even further, in particular when the economic climate becomes more gloomy. However, if all lending becomes short term, the vulnerability of borrowers will rise substantially and the intrinsic liquidity of their liabilities may be much lower than if the maturity of their exposures had been kept more medium term.

In sum, instead of helping to build a stable equilibrium for a diversified set of profit-maximising agents, the market mechanism may at times fall prey to one-dimensional views and become one-sided, producing highly volatile outcomes and price overshooting. It would be too much to say this was the cause of the Asian crisis, but it may have contributed to its unexpected virulence.

Inadequate infrastructure

A final major area of fragility in financial markets is that of an insufficiently developed infrastructure. Financial market infrastructure covers a very broad range of elements. It includes modern contract law and efficient law enforcement procedures. It deals with accounting rules and valuation standards, with prudential regulations, effective supervision and appropriate disclosure requirements. It also covers the creation of well-functioning payments and settlement systems and the design of safety net provisions.

In many respects, this infrastructure is a public good. It is of benefit to all, but market participants will not be able or willing to supply or fund it fully. It will therefore be left to the relevant authorities to ensure that the necessary infrastructure is put in place and ways are found to share its cost among participants.

Financial history if replete with cases of crisis which were caused by poor supervision, inadequate legal frameworks or deficient payment and settlement arrangements. This shows how complex and expensive a well-performing infrastructure is, in particular in an international context. It also explains why so often these public goods are being undersupplied and markets often remain immature.

Moreover, the financial infrastructure may propagate biased incentives and excessively risky behaviour as long as its design is faulty and pricing inappropriate.

In the case of countries affected by the recent crises, financial supervisory arrangements were almost always deficient in some respects. Accounting conventions were applied insufficiently rigorously, and financial institutions were allowed to become excessively exposed. In some countries, bankruptcy arrangements were virtually non-existent, and in those where they existed, they were often subject to delays. Hence the process of recovering value from impaired financial claims (an essential part of a well-functioning financial system) was burdened by major uncertainties. In Russia, the costs of the absence of reliable contract law and law enforcement are at their most evident.

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It is now time for me to move from problems to solutions. But first, let me briefly recapitulate the argument so far. Open markets continue to be the most appropriate and efficient arrangement for allocating resources and bringing about adjustment. From this perspective, there is no real alternative to the present basis for financial intermediation, both domestic and cross-border. However, this firm belief should not blind us to the inherent vulnerabilities which characterise financial markets. I therefore now propose to explore for a few minutes the approaches we may take to find solutions to these market failures.

Information

First, how to ensure that market participants have adequate access to the information they need? An impressive list of recent initiatives in this area can be put together. The efforts have moved in three distinct directions. Some have been aimed at improving participants' appreciation of the risks in the macroeconomic environment. The IMF's Special Data Dissemination Standard is an example of this kind of initiative, as are efforts to improve the consistency of international reserve data. Others have sought to increase our understanding of the potential implications of the build-up of market positions and price trends in particular markets; examples of this effort are the more timely international banking statistics provided by the BIS. Still others aim at sharpening awareness of the creditworthiness of counterparties; the work of private sector groupings in laying down more rigorous counterparty credit guidelines should improve disclosure practices in this area.

But rather than elaborate on specific initiatives, I would prefer to make two more general observations. *First*, unlike what financial news services would like us to believe, the main issue that confronts us is not so much to generate ***more*** information, but ***better*** information. Relevant, clear and comprehensive information, and its efficient disclosure and dissemination, are what is called for. From the point of view of the authorities, the challenging task here will be to transmit the correct guidance to financial markets and participants. Blanket guarantees and time-inconsistent commitments to exchange rate targets have all too often been part of the messages which the authorities have conveyed to financial markets. The recent crises in much of the emerging world have shown how counterproductive, if not disastrous, this market guidance can be.

My *second* point is that not only do we need to consider carefully what the right information is, we also have to put in place the appropriate incentives for participants to use and disclose it. Awareness of this incentive issue can be found in the proposed revision of the Basel Capital Accord. For instance, sovereign risk weights are expected to be lower for those countries which have reached internationally accepted standards with respect to data dissemination. More importantly perhaps, the new accord's call for more comprehensive qualitative supervision, rather than the mechanical checking of quantitative ratios, is likely to induce banks to focus on their risk management and monitoring capabilities, and thus on their ability to incorporate all information that is relevant to risk control. There is little doubt in my mind that the encouragement of a credit culture which requires lending officers to realistically appraise the credit and market risks of their portfolio or investment decisions will generate many incentives to use and disclose market-relevant information.

Externalities

I come now to the second area of market vulnerability, that of undesired externalities and aggregation problems. This may be even more complex. In theory it is course possible to consider the radical solution of forcing financial institutions to reduce their leverage and increase the degree of their liquidity so much that a run on them becomes highly unlikely. Similarly, one could consider pushing countries into holding a sufficiently large stock of international reserves which would reduce the likelihood of currency runs to a minimum. However, the costs of such measures in terms of efficiency and economic growth would be large. The financial sector makes its contribution to the wider economy by adding to the liquidity of intersectoral claims. This depends on leverage. To reduce its capacity to this would involve economic costs. We therefore need to strike a balance between efficiency and stability objectives.

Much more constructive, I feel, would be to improve our understanding of how financial regulation can give rise to aggregation issues and generate externalities. Greater awareness of the link between individual behaviour and market outcomes can contribute to better rules and more appropriate market guidance. As a result, the incidence of capital flow volatility would be less. More discriminating and critical behaviour on the part of market participants may be promoted, and a bunching of particular types of lending and investment might be more easily avoided.

No doubt, many controversial issues will have to be dealt with in this area, and solutions which seem adequate from one point of view may be questionable when looked at from a different angle. For instance, the pressure to maintain prescribed capital ratios is sometimes argued to have undesirable macroeconomic consequences. The need to satisfy capital requirements can aggravate economic recessions, if banks feel forced to curtail their lending beyond what the underlying economic situation would warrant. Similarly, a comfortable capital cushion in economic booms may induce banks to engage in lending sprees. To the extent they have pro-cyclical effects, capital requirements may generate externalities and aggregation effects.

Some have accordingly argued that institutions should be allowed to run down capital in recessions and rebuild it in periods of greater economic buoyancy. Whatever the appeal of this argument, however, it ignores the fact that a capital cushion is needed precisely when economic conditions are adverse and confidence is shaky. A policy which appears beneficial to the macroeconomy could then be harmful to the soundness of the financial system and, through this channel, put economic stability in even greater danger. If, therefore, banks' capital is to serve its purpose as a cushion in bad times, it follows that banks should hold additional capital reserves when times are good.

Infrastructure and public goods

Finally, what could be done to ensure that sufficient public goods are supplied for an efficient functioning of financial markets? Governments have generally accepted the responsibility at the domestic level to provide the main elements of the infrastructure which financial markets need. Unfortunately, most of these domestic initiatives cannot be simply transposed to the international level. Insolvency arrangements may be effective within national boundaries, but remain complicated, even non-existent, when the insolvency involves sovereign states or relates to cross-border claims. Supervision remains in the hands of national regulatory authorities, creating difficulties of communication and coordination once financial activity becomes more global. The problem is further compounded by the fact that different types of financial institution are often supervised separately and according to differentiated rules. To a certain extent, the "Core Principles" for effective supervision developed by the various regulatory bodies, address these problems; however, their implementation still has to proceed much further.

Safety net provisions promote the stability of the domestic financial system, but are discussed at best in a conceptual or abstract manner at the international level. Even in areas which seem more manageable, such as the definition of appropriate accounting standards and valuation principles, international acceptance and uniformity are still a long way from being realised. Most of these issues

are being addressed in various expert groupings, but the complexities of the issues at hand limit the speed at which progress can be made.

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If we are to make significant progress in proposing solutions to and correcting the main financial market failures, strategy will be an important consideration. By this I mean, how does the international community go about reaching agreement on how market failures are tackled, then ensuring that the necessary measures are implemented.

The first thing to say is this is not an area that lends itself to international treaties. Prudent financial behaviour is not something that can easily be reduced to legislative provisions. For a variety of reasons, the most promising approach appears to be the development of standards of best practice, whose implementation is encouraged by market forces, and effectively monitored by impartial assessment. For this approach to gain broad acceptance, it should, first of all, be the outcome of a legitimate process of standard setting. By this, I mean that the task should be carried forward by national experts who from their own direct experience are familiar with the practical issues of best practice and how to promote it. Legitimacy also implies that a representative sample of countries should be involved or consulted.

Second, discussions need to focus on the many ways in which measures in one area impact on other areas. Supervisors of banks, for example, need to be aware of how their activities impact on the choice between bank finance and other forms of intermediation. More generally, there needs to be a better appreciation of how "environmental" factors such as corporate governance practices, accountancy conventions and bankruptcy arrangements affect the balance of risks and incentives in the financial sector. And third, the general purpose of the exercise should be to promote a better understanding and pricing of risks, not so much by administrative directives and regulation, as through the reinforcement of appropriate incentives and behaviour.

In much of the committee work done at the BIS, attention is given as much as possible to these principles of strategy. By focussing on the soundness of institutions (via the Basel Committee on Banking Supervision), the functioning of financial markets (via the Committee on the Global Financial System) and the development of the market infrastructure (via the Committee on Payment and Settlement Systems) committees have sought to address the multifaceted nature of financial intermediation. By relying on consensus building among national experts and by encouraging the active involvement of major emerging market economies, the legitimacy of the "Basel process" has become more widely accepted. And increasingly, the propagation of appropriate incentives have come to dominate committee recommendations.

However, financial stability is not the preserve of a few committees or institutions. It is the combined responsibility of central banks, supervisory agencies, ministries of finance, international organisations and standard-setting bodies that have been created within the various segments of the financial market. The G7, in a report by Hans Tietmeyer, recognised the need to establish an institutional setting in which all these agencies charged with financial stability could be brought together. The proposal led to the establishment earlier this year of the Financial Stability Forum, which I have the honour to chair. Its agenda focuses on increasing the awareness of the inter-relationships between the various aspects of financial stability, promoting the exchange of information and the identification of gaps, and enhancing the efficiency of standard setting. In other words, the Forum seeks to address the three areas identified as major sources of vulnerability in financial markets.

Its composition reflects the diversity of interests in financial stability, and could so help to foster greater understanding of the macro/microprudential interface among those charged with supervision and standard setting and those concerned with macroeconomic stability. Finally, it may also help to deal with what is to be considered the four-letter word in financial stability, namely the issue of "turf" or the unproductive competition or lack of cooperation between agencies charged with overlapping responsibilities.

The Financial Stability Forum brings together a wide cross-section of individuals and institutions involved in the promotion of financial stability. The G7 countries are represented by their Deputy

Finance Ministers, Deputy Central Bank Governors and Heads of Supervision (in the case of Germany, this means Caio Koch-Weser, Jürgen Stark and Wolfgang Artopoeus). In addition, four other countries with systematically important financial markets are represented. The major international institutions (the IMF, World Bank, OECD and BIS) also participate, as do the main standard-setting bodies – the Banking, Insurance and Securities Regulators and the international Committee on Payment and Settlement Systems.

As you see, therefore, the Forum is well constituted to take a comprehensive view of financial stability issues. It has also incorporated the views of a wide range of countries not directly represented in the Forum through their participation in Working Groups. At its inaugural meeting, the Forum decided to set up three working groups covering, respectively, Highly Leveraged Institutions, Offshore Financial Centres and Capital Flows. I expect these working groups to deliver their final reports in March. The reports themselves will contain a number of concrete, implementable recommendations that, when adopted, will have the effect of making the financial system safer.

I mentioned a moment ago the role of standards of best practice as a means of focussing efforts to improve financial system stability. Of course the drawing up of standards has to be accompanied by a means to encourage their implementation. The Forum is addressing this issue in a newly-established working group chaired by Andrew Sheng of the Hong Kong Securities Commission. Effective implementation requires *incentives* to put standards into effect, *prioritisation* to ensure that the key weaknesses are tackled first, *monitoring* to assess compliance, and often *technical assistance*, to give supervisory authorities access to relevant knowledge and expertise. I believe the Forum can play a key role in bringing together the resources in its various members to help bring all this about.

Lastly, let me note briefly the role of the Financial Stability Forum as a source for information. The Forum's website contains a compendium of the standards (43 in all) that have been developed in the financial area. It also contains an inventory of training availability. We will be building up this facility in the future to provide, we hope, a genuine focal point for sharing information on initiatives in the field in financial stability.

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In conclusion, the market-led system of financial intermediation has served the world very well, *most of the time*. By lifting the liquidity constraints inherent in administrative controls and excessive regulation, today's financial arrangements have contributed to output and income growth of enterprises and households alike. The most vivid illustrations of the potential of open financial markets to raise efficiency and improve resource allocation are the spectacular growth rates which several emerging market economies realised over the last two decades.

But recurrent bouts of financial turmoil, not least in those high-performing economies, also demonstrate that financial markets do not always work efficiently and produce competitive outcomes. I have concentrated here on three types of market failure which can cause major financial shocks and damaging instability. For some these failures are sufficient ground for advocating a return to administrative control of financial activity. I do not share this view. But I am honest enough to recognise that much still needs to be done to mitigate the vulnerabilities in financial markets. And modest enough to admit that this will be a protracted process, heavily dependent on the political will to succeed.