William J McDonough: Toward greater financial stability

Remarks by Mr William J McDonough, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Bank of Thailand, Bangkok, 5 February 2001.

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It is my pleasure to accept the invitation of the Bank of Thailand to speak to you tonight on how we can promote greater financial stability.

In the wake of the Asian crisis, authorities in the region have done much to promote increased financial stability, through a variety of measures to strengthen domestic banking systems and corporate sectors, and institute broader improvement in accounting, legal, and supervisory systems. Thailand has taken a number of such actions, including efforts, among others, to close troubled financial institutions, attract significant private sector capital (including foreign capital) into the banking system, and improve the legal framework. Macroeconomic policy adjustments, including the move to flexible exchange rates, have also furthered greater stability. These actions have helped countries recover from large-scale banking crises, and restore solid growth generally.

That said, in Thailand and elsewhere, the recovery is not yet complete, and much remains to be done. Moreover, the restructuring and reform agenda will be challenged by slowing global and regional growth, which may contribute to already apparent signs of increasing reform fatigue within the region.

In my view, Asia stands at an important policy crossroads, involving a choice between pushing forward market-based reforms that are the only way toward long-term financial stability, or pursuing actions that provide short-term relief at the risk of threatening the hard-won gains of the last three years.

The recognition that we have entered a new international financial environment has set in motion a range of efforts dedicated to strengthening the new international financial architecture. My remarks today will focus on what I believe can be done, from my perspective, to enhance domestic financial resiliency, within the context of these international efforts, and particularly on two essential building blocks: a strong financial system and a sound and stable macroeconomic environment. My comments reference the experience of East Asia, but reflect lessons that are more broadly applicable.

Overview of recent recovery

Given the depth of the problem a little more than three years ago, the Asian recovery on the whole has been remarkable, and has largely defied initial expectations that the crisis would cast a long shadow over regional growth prospects. The regional recovery has exhibited a solid "V" shaped trajectory supported by strong performance in the external accounts, and a pickup in domestic demand. Banking sectors – faced with unprecedented crisis three years ago – have been shored up through substantial capital injections and problem asset carve-outs. Corporate sector conditions also appear to have improved notably with the advent of recovery and debt restructuring efforts.

At the same time, authorities in a number of Asian countries initiated a wide range of fundamental enhancements to financial system infrastructure, including strengthening prudential regulation and supervision, bolstering bankruptcy and collateral recovery processes, and improving disclosure requirements. With the full implementation of these measures, standards in Asia will closely approximate international norms.

Reform fatigue

But with the pace of growth slowing, reform fatigue represents a significant risk to sustained recovery.

Crises entail wrenching change and costly solutions that are difficult to bear over a long period. The desire for a return to "normalcy" is strong. Under these conditions, it is human nature to overemphasize positive information, tire of reform, declare victory and move on. These impulses might be expected to be particularly powerful against the backdrop of years of strong and unbroken Asian economic growth.

It is no wonder therefore that governments the world over initially tend to underestimate the size of problems, underfund solutions, and postpone loss recognition. It also is not surprising that, given the many obstacles involved, authorities may be tempted to prematurely mark a case closed, particularly with the advent of economic recovery.

In the new international financial landscape, a government's perceived ability to deliver on the policy front is crucial, preferably based on coherent, comprehensive, and achievable objectives. Confidence in a government's ability to deliver is nurtured both by actions and by communication. Complacency and reform backsliding, however, create the dangerous potential for a shift in expectations.

Vulnerabilities

On a microeconomic level, the still-fragile condition of regional financial and corporate sector institutions remains a real threat to medium-term stability.

Notwithstanding significant official rescue efforts, regional financial sectors remain burdened by a high level of problem loans, and require further substantive bolstering of capital and reserves. Authorities, by and large, have yet to articulate a program for reprivatizing banks and liquidating purchased assets. Improvements in the financial system infrastructure depend critically on follow-through on these issues, a long-term process.

Corporate sectors similarly remain fragile: recent debt restructurings have involved a high degree of debt rescheduling, and firms across the region remain burdened with significant amounts of debt. The relatively limited restructuring of corporate operations to date across the region raises questions about the medium-term sustainability of recent improvements in bank asset quality.

The relative lack of breadth in the region's recovery also creates vulnerabilities. Asia's export orientation has long been a key focal point of strength, to which the recent recovery attests. However, too great a dependence on export-driven growth brings increased vulnerability to external shocks.

Asia, in particular, will feel the negative effects of a worldwide slowing from last year's strong rate of growth. Moreover, domestic demand has not recovered sufficiently from the crisis to sustain the region's economies. With fiscal policy constrained to varying degrees by heavy public sector debt burdens, regional central banks, in some cases with new-found independence, will need to maintain their stimulative policies to support the recovery.

Unfinished business

While important progress has been made in rehabilitating Asia's financial systems, a great deal remains to be done to continue the strengthening of weakened financial and corporate sectors, and improve the region's resistance to future problems.

I am well aware that universal policy prescriptions are difficult to draw, given the wide range of experience and initial conditions. Indeed, individual countries in Asia have followed differing reform strategies, and the results of these efforts will help to inform the ongoing debate. Nonetheless, I am fond of citing a few of the cautionary lessons from recent international experience with financial sector reform:

- *Restructuring and reform must adequately address both the current "stock" of problem assets, as well as the potential "flow" of new problems attributable to deficiencies in the broader financial system infrastructure.* Lack of adequate action on either front can lead to a continuation of the substantial costs of weak banking sectors, sometimes well beyond the immediate crisis itself.
- *Clean-up efforts must be sufficient to the task.* Half-done measures that leave financial institutions with significant levels of impaired assets at best postpone the reckoning and potentially create incentives for excessive risk-taking.
- *Fundamental improvements in bank corporate governance are critical.* Just as risk management and internal control processes usually need to be thoroughly overhauled in weak institutions, more often than not, so too does management.
- *Protracted forbearance to preserve the appearance of solvency is not a solution.* While some degree of forbearance may be unavoidable and even appropriate under the right conditions, it is at best a temporary measure. It is critical that forbearance not become institutionalized,

but be tied directly to actions by both bankers and supervisors to address underlying problems.

- *Governments are not good long-term asset managers.* Prolonged government holding of impaired assets is not likely to enhance their value, nor aid in the restoration of market liquidity.
- *Governments are not good commercial bankers.* Delayed privatization of nationalized banks always means higher future costs, and usually inhibits fundamental reform.
- *Government-directed lending means future fiscal losses.* Similarly, efforts to stimulate credit growth by nonmarket forces in the context of a banking crisis at best buy additional time, and usually dig a deeper hole.
- *Foreign investment in domestic financial sectors can yield important benefits.* Foreign direct investment in the banking sector can provide much-needed capital resources, technology and knowledge transfer, and a more diversified capital and funding base in the event of future economic instability.
- *Financial sectors are only as healthy as their borrowers.* Without corresponding corporate sector restructuring, financial sector rescue efforts are likely to be necessary in the future.
- *Strong financial systems depend on a reliable and credible legal system.* In the absence of a strong legal system, borrowers lack appropriate incentives to repay.
- *There are no "quick fixes" to financial sector problems.* Remedial actions need to be evaluated in terms of their short-term efficacy as well as their longer-term implications.
- *Unbalanced financial systems create vulnerabilities.* Financial systems that are unduly reliant on banks for financial intermediation are likely to be more vulnerable and slower to recover from the onset of weakness. Shallow capital markets limit lending alternatives and delay the recovery of financing to the real sector.

The challenges can be daunting, but recent experience both within and beyond Asia confirms that a dedicated commitment to financial reform contributes to sustainable recoveries and greater crisis-resilience. Just as strong financial systems act as stabilizers when a domestic economy is battered, weak financial systems amplify the scope and reach of the problems, making bad situations worse.

Longer-term financial stability

While financial sector rehabilitation will remain a key priority for authorities in Asia, longer-term measures need to be put in place to deal adequately with the increasingly complex and dynamic international financial marketplace of the twenty-first century. The threats to financial stability are many, and no one set of measures can be expected to ensure against the recurrence of future problems. Financial intermediation is a constantly evolving activity, involving new risks, instruments, and control challenges. Financial institutions and policymakers alike should continue to upgrade their processes to remain in command of these risks.

Stability ultimately can be served only by the collective interaction of the three pillars of:

- sound leadership at the firm level;
- effective market discipline;
- and strong prudential regulation and supervision.

Sound leadership at the firm level is the first bulwark against financial system instability, and begins with capable and experienced directors and management, a coherent strategy and business plan, and clear lines of responsibility and accountability. The execution of overall objectives must be supported by rigorous internal controls and effective risk management. The importance of a strong institutional credit culture cannot be stressed enough.

The second line of defense is effective market discipline, an increasingly important ally of policymakers in a global marketplace. Of course, market discipline must be supported by substantial disclosure, sound accounting standards, and an efficient and credible legal framework.

While effective bank-level management and meaningful market discipline are crucial elements of an overall strategy for promoting and preserving financial stability, neither can substitute for the critical role played by official supervision. The Basel Committee on Banking Supervision, which I chair, has identified the necessary ingredients of sound supervision, and these principles must be applied to all internationally active banks within a more dynamic, risk-based, and process-oriented framework.

Strong regulation and supervision is a crucial part of achieving financial market stability and the proposed revisions to the International Capital Accord that were released in January by the Basel Committee will set the standard for banks around the world.

Recognizing the clear need for a more risk-sensitive and flexible Basel Accord, the new framework is intended to more closely align regulatory capital requirements with underlying risks, and to provide banks and their supervisors with a range of options for the assessment of capital adequacy.

There is more emphasis on banks' own internal methodologies as well as other elements that are critical to ensuring the capital adequacy of banks, such as strong risk management and sufficient public disclosure of information. The Committee has also discarded the one-size-fits-all framework for the calculation of minimum capital requirements. Instead, the proposed framework provides a menu from which banks can choose, with the authorization of their supervisor and depending on the complexity of their business as well as the quality of their risk management.

The Basel Committee is seeking comments on the proposed framework until the end of May and plans to finalize the new Accord well before the end of this year, during which time the Committee will pursue an active dialogue with non-G10 supervisors. It is envisioned that the revised Accord will be implemented in 2004.

The role of a sound and stable macroeconomic environment

A sound and stable macroeconomic environment is also crucial for financial stability, and more generally for promoting sustainable growth. The converse--macroeconomic overheating--raises the likelihood of an eventual crisis, first by promoting excessive, and eventually unsustainable, external and internal borrowing. The next step inevitably is the correction to the real economy, interest rates and/or the exchange rate, that can sharply worsen asset quality and expose the accumulated weaknesses in the financial system.

Role of central banks in promoting stability and growth

A central bank's most important role in achieving stable, long-term growth involves promoting price stability. Achieving long-run price stability is a difficult and continuous challenge, as it requires constant efforts first to detect, and then to correct the building up of internal and external imbalances. Moreover, because of time lags in policy effectiveness, authorities often have to take action based only on partial evidence, well before adverse symptoms are fully evident. The principal reward for forward-looking policy is that changes in policy, and the associated stresses they engender, are generally smaller and more easily assimilated by markets. The effectiveness of monetary policy naturally brings us to the question of monetary and exchange rate regimes.

A great deal has been said in various forums about the choice of monetary and exchange rate regimes. I believe it is crucial that there be consistency between a country's choice of currency regime and its other policies. There is no "right" regime that applies to all cases and all points in time. Experience has shown that no currency arrangement can compensate indefinitely for imperfections elsewhere in an economy, such as weaknesses in financial supervision, an excessively loose fiscal stance, or inflexible wages and prices. Furthermore, no exchange rate regime can offer full insulation from cross-market spillovers, particularly where the free movement of capital is allowed. Nevertheless, certain policy combinations can make things far more dangerous. Fixed, but adjustable, regimes look to be particularly fraught with perils when combined with shortcomings elsewhere, not the least of which are the severe after-effects that always seem to follow their forced abandonment.

As you are aware, much of the emerging world has moved toward floating rates in recent years. For Thailand and the other countries that have made the change in East Asia, it would appear that the new monetary/exchange regimes, despite their very difficult starts under the most inauspicious of circumstances, now appear to be serving countries well. Inflation is in the very low single-digit range in most of the newly floating economies, and in many instances the successful effort to bolster monetary credibility has been reflected in short-term interest rates that have declined to historically low levels.

Moreover, authorities have gained new degrees of freedom to manage their economies and to respond to changing internal and external circumstances.

But if the promised benefits of monetary discretion are to be fully realized going forward, markets need to understand the objectives and the framework by which the monetary authorities will decide future policy actions.

In this regard, I would note that some countries, including Thailand, have looked to inflation targeting as a framework to accomplish that end. And indeed, inflation targeting would seem to have much to recommend it, provided that it is approached not as a panacea, but rather as a pragmatic organizing framework for policy. In other words, policy frameworks such as inflation targeting can be useful where they signal a disposition towards continuous and predictable communication, and a forward-looking, informative policy approach. But as I said, inflation targeting per se is not a sure-fire solution – for example, the costs of disinflation do not appear to be lower in inflation-targeting countries – nor is it a prerequisite for effective communication and ultimately effective policy.

Role of fiscal policy

Clearly, crisis prevention through promoting stable and sustainable conditions in the macro-economy is not solely the province of central banks. Sound fiscal policies are needed to complement the effectiveness of even the soundest monetary policies. Chronically loose fiscal policy is a persistent threat to macroeconomic stability, through the build-up of internal and/or external debts that can be devastating.

For the countries of East Asia, the public sector’s generally low initial indebtedness provided important latitude for dealing with the recent crises. Governments had room to stimulate aggregate demand recovery through fiscal ease; moreover, extensions of public guarantees and capital helped to contain the banking crises.

However, while initially strong fiscal positions provided flexibility to address financial sector problems and aid recovery, public debt has since risen to high levels in a number of countries, and contingent liabilities often remain significant, raising some concern about potential future debt growth.

Thus, governments now face the challenge of moving to retighten fiscal policy in the face of slowing economies, and over the longer term, gradually restoring their earlier prudent levels of net indebtedness. These considerations further underscore the importance of quickly completing the process of banking sector rehabilitation and of attracting new sources of capital. Such decisive action would allow the banking sector to again be an engine of growth, capable of offsetting the eventual withdrawal of fiscal stimulus.

Conclusion

In closing, the recovery in Asia has been impressive indeed, and owes much to the energy and hard work of its people, enlightened political leadership, and the substantial and focused efforts of policymakers to implement sound macroeconomic and financial policy. But the recovery is not yet complete and much remains to be done.

While the crisis did substantial damage, it has not fundamentally affected Asia’s prodigious economic strengths. But if Asia is to realize its potential, it is critical that authorities attend to the unfinished business that remains while continuing to put in place longer-term measures to promote financial resilience, ensure the sustainability of public sector debt burdens, and encourage sustainable growth. Asia is at an important crossroads and there is now a unique opportunity to consolidate recent reforms and implement lasting change that will pay dividends for years to come.

Thank you for your kind invitation and attention. I would be happy to take any questions you may have.