Mr. Crockett discusses financial stability and international capital flows

Keynote address by the General Manager of the Bank for International Settlements, Mr. Andrew Crockett, to the 33rd Seacen Governors' Conference in Bali on 13/2/98.

Financial stability has always been a major responsibility of central banks. In recent years, it has become even more important because of the increased capacity of financial disturbances to spill over into the real economy. One need look no further than the difficulties currently facing the economies in East Asia to appreciate the consequences of weak financial systems. The task of maintaining stability has also become more complex: liberalisation and innovation have brought benefits but they have also made national financial systems more vulnerable, both to domestically-generated stresses and internationally-transmitted disturbances.

In my remarks this morning, I will begin by reviewing some of the forces making for change in the financial environment. Then I will consider the implications of the changes that are taking place for central banks' task of preserving monetary and financial stability. Finally, I will try and draw one or two concrete lessons from our most recent experience.

Basic trends in the international financial system

It is no exaggeration to say that the international financial system is undergoing a process of unprecedented change. Among the most significant driving forces are advances in communications and information technology. By dramatically lowering the cost of financial transactions and broadening the dissemination of financial information, these advances have expanded trading and investment opportunities and are exercising powerful effects on the scale and structure of financial intermediation. One notable effect has been to enhance the role of markets, whose task it is to transmit information about the value of assets among borrowers and lenders. This in turn is forcing traditional intermediaries to redefine their roles.

A second important force for change is innovation, which has permitted the development of products that facilitate the pricing and management of risk. This too has expanded the effective bundle of financial services on offer. By allowing risks to be hedged, they allow non-financial enterprises to focus on their comparative advantages. But they also facilitate speculation, and the more rapid adjustment of positions taken. They also strengthen linkages between markets in ways that are not yet fully understood.

Another key impetus to change, though also a consequence of it, has been market liberalisation. This applies both to the removal of constraints on the activities of different types of financial institutions within a given market, and to the liberalisation of cross-border capital movements and rights of market access. As a result of liberalisation, a broader range of institutions can now provide financial services; and an increasing number of both markets and institutions are active across national boundaries. This has greatly extended the reach of competition and forced the modernisation of market practices in far flung centres.

A consequence of the forces for change I have just described has been a rapid expansion in the scale of financial activity relative to overall economic activity, and of international as against purely domestic activity. This in turn has generated unquestioned benefits in terms of more efficient global resource allocation. At the same time, the greater *masse de manoeuvre* in financial markets has increased the power of market expectations to reinforce or undermine official polices. And the growth of the financial superstructure relative to the economy as a whole means that any sustained disruption to the financial system now has potentially broader economic effects than might have been the case previously.

Consequences of Changes in the financial environment

For emerging markets, the consequence of these trends has been that they have rapidly become integrated in international capital markets. This has had a number of advantages. Private debt or portfolio inflows in response to economic liberalisation have expanded sizeably, from less than $40 billion per year over the period 1983-1990, to an average of about $200 billion a year in the last five years. These capital inflows have provided additional resources to supplement domestic savings and support high levels of investment. Foreign direct investment has also grown sharply. This has in many cases been a vehicle for the transfer of technology, and in others a competitive spur to domestic industry. And the market disciplines that accompany greater economic openness have provided timely and forceful penalties on inappropriate policies. By the same token they have reinforced the premium on strong and sustainable macro-economic policies.

But greater capital market integration and larger capital flows have also had less beneficial consequences. These have been much in evidence in the experience of Asian countries in the past year. In a different form, however, they were behind the Mexican economic crisis of 1994-5 and indeed some of the problems encountered in the European Monetary System in the early 1990s. When countries have become excessively dependent on foreign inflows, their sudden reversal can generate significant adjustment difficulties. Let us consider what has now become a typical sequence of events, with a view to drawing some lessons that can help avert costly crises in the future.

Countries undertaking strong stabilisation and structural reforms have often found themselves a magnet for foreign capital. Capital inflows have been even greater when domestic economic growth in the receiving countries has accelerated, and when low interest rates in the sending countries has encouraged lenders to reach for higher yields. The inflows, in turn, have either contributed to inflationary pressures (when there is a fixed exchange rate) or led to currency appreciation (when the exchange rate regime is more flexible). Either way, external competitiveness has tended to deteriorate and a balance of payments deficit has emerged.

A balance of payments deficit is a natural counterpart of a situation in which domestic investment exceeds domestic saving. In itself, therefore, it is no bad thing. But if it is financed by capital inflows that are liable to dry up or be reversed, it can put the country concerned in a vulnerable position. A feature of capital flows in the new, more integrated international capital markets, is that a high proportion has been in the form of short term lending, denominated in foreign currency. This has been encouraged by significant interest differentials in favour of the borrowing country, and an exchange rate regime that has masked the risk of exchange rate changes.

Thus, when growing payments imbalances, or some external event, causes investors to re-evaluate the sustainability of exchange rates, there is liable to be a sudden withdrawal of funds. This can quickly lead to a currency crisis, with all the consequences we have seen in recent months. Then, if there are financial weaknesses within the domestic economy, the negative effects on output and growth can multiply.

Lessons of the Recent Crisis

With what I have just said as background, allow me to consider certain preliminary lessons that can be drawn from the current crisis. Naturally, a more thorough analysis of how to prevent such crises in the future will have to await a longer perspective on events.

A first lesson is that even economies with relatively strong fundamentals, and fairly sound macro-economic policies, can fall victim to sudden loss of confidence. Why should this be? One reason is that even good macro-economic policies require adjustment in the light of evolving circumstances. This flexibility was not always there in the case of the countries most affected by the crisis. Let me expand a little on what I mean. When strong capital inflows are pushing up the exchange rate and undermining external competitiveness, monetary policy often finds itself in an acute dilemma. On the one hand, higher interest rates may be required to dampen an investment boom. On the other, lower interest rates may be needed to moderate the inflow of short-term speculative funds. In these circumstances, monetary policy needs assistance from fiscal policy: a budget surplus may be needed to curb domestic demand, and to provide the financial resources to sterilise the foreign exchange inflow.

Flexibility is also needed in the area of exchange rate management. I do not mean that countries should always adopt freely floating exchange rates. That would not necessarily be an optimum policy in emerging markets, whose financial systems are not fully developed. For example, Hong Kong and Argentina have successfully operated a currency board type system for the past several years. But the exchange rate regime must be adapted to the capacity of domestic policy and institutions to take the burden of adjustment. Where political or other factors make it difficult for domestic adjustment mechanisms to take the strain of reversals in capital flows, then the exchange rate has to be the safety valve. If the exchange rate regime makes it difficult to make timely changes in the external value of a currency, then disequilibria can build up that add immeasurably to the abruptness and costs of the eventual adjustment.

This is not just the recent experience of East Asian countries. It was the experience of Mexico in 1994-5; and it was a substantial part of the explanation of the turmoil in the European Monetary System in 1992-3. I know from the experience of my own country, where I was closely involved in decision-making at the time, that it is extraordinarily difficult to make changes in an exchange rate peg that has come to symbolise an overall macro-economic strategy. I also know that the penalties for not making an adjustment in time are severe. Which leads me to the conclusion that governments should seek an exchange rate regime that avoids this dilemma unless, as is perhaps the case in countries with currency-board arrangements, they are prepared to accept the full rigour and logic of fixed rates.

So much for the macro-economic origins of currency crises. What of the macro-economic responses. Some have argued that the stringent monetary and fiscal policies advocated by the IMF are inappropriate, because they intensify the financial problems of indebted firms and deepen the internal recession. While I have some sympathy for this view, I am afraid I cannot see any easy policy alternatives when a country finds itself in a full-scale crisis. In such conditions, the first priority is to restore external confidence, and this can rarely be achieved without a clear commitment to monetary restraint. Perhaps the most important lesson is the need to seek external assistance and to adopt corrective policies before problems reach the crisis stage. An early policy response can be more accurately targeted to the underlying causes, and the macro-economic consequences can be less severe.

One of the clearest lessons of the experiences both in Mexico and in East Asia is the role of weaknesses in the financial system in propagating economic disturbances. This is a consequence of the growing integration of international capital markets, and will certainly not be reversed. If anything, markets are likely to be even more closely tied together over time. There are several more specific lessons to be drawn from this recognition. In the first place, liberalisation in the domestic financial system, and in the openness to the world capital market must be accompanied by measures to strengthen prudential regulation and supervision. For those countries that still have capital account restrictions, this means that the dismantling of capital controls will have to be carefully phased and sequenced. It may also mean that existing prudential safeguards, such as liquidity ratios, reserve requirements, exposure limits and controls over currency and maturity mismatches in banks' portfolios, may have to be strengthened.

More generally, however, the recent crisis has revealed that many banking and financial systems continue to embody practices that make them vulnerable. These practices relate to inadequate internal controls, non-transparent accounting standards, weaknesses in loan approval procedures, lax licensing provisions, insufficient capital adequacy requirements, and uncertain closure procedures, among others. Because these weaknesses are widespread, and because there was no internationally accepted standard of banking prudence, the Basle Committee on Banking Supervision promulgated last year a set of 25 "Core Principles" for banking supervision. Implementing these principles should make an important contribution to strengthening banking and financial systems around the world.

The Core Principles represent an important new step in the work of the Basle Committee. For that reason, I would like to draw your attention both to certain aspects of the philosophy underlying their preparation, and to some of the specific recommendations. In the first place, the Core Principles are intended to be comprehensive in their coverage. That is to say, they apply to all phases in the life of a bank, from initial licensing, through continuing supervision, through closure procedures for institutions that are unable to meet minimum standards. They are also comprehensive in their institutional scope: they are intended to apply to both domestic and internationally active banks, coming from industrial, emerging and less-developed economies. Lastly, and very importantly, they have been drawn up with the active involvement of supervisors from a wide range of countries, including most of the key emerging market economies, including some central banks represented here.

Let me now turn to some of the specific recommendations, and to ways in which bank supervision can work to strengthen bank soundness. One of the key foundations of the Basle Committee's approach over the years has been the focus on risk-weighted capital adequacy. This remains as important as ever, but it is clear that the way in which the current standards are expressed has not prevented major episodes of instability. Part of the problem lies in the fact that insufficient attention is given to the fact that the minimum capital requirements are just that: minima. What can be acceptable for a strong, well-managed, well-diversified institution in a major financial centre is likely to be inadequate for a bank operating in a more volatile environment, where credit and market risks are much greater. Some supervisors in emerging markets have recognised this and have set higher minimum standards. Singapore and Argentina are good examples in this regard. I hope their initiative will be followed more generally.

But it is not simply the formal capital ratio that needs to be considered. In very many countries banks fail despite the fact that they were in apparent compliance with minimum capital ratios shortly before their collapse. This points to deficiencies in accounting standards, which, quite simply, allow bad loans to be classified as good. Bank supervisors will have to insist on much more rigorous standards of loan classification and bad debt provisioning. They will also have to insist on greater transparency in financial accounts, so that problems can be identified before they grow to life-threatening proportions.

Of course, at the root of balance sheet weaknesses are poor lending decisions. Not all of these can be prevented by better banking supervision. Improved information on borrower conditions is clearly a first step. A comparison by lenders of the return prospects of large local projects with return requirements prevailing internationally is another. Other sources of excesses can certainly be tackled. Some of these arise from what has come to be called "insider" or "connected" lending. A variant of this practice is the policy loans that are encouraged by political authorities who, for whatever reason, are unwilling to make direct budgetary provision for expenditures. The core principles make it clear that credit decisions by banks should be made purely on economic grounds. This means that credit officers in banks should have the training and the mandate to make prudent decisions; and that supervisors should have the independence to enforce best practice in the banks they supervise.

Before leaving the subject of how to strengthen financial systems, I would like to make a more general point about leverage. We all know that banks can get into trouble when they are too-highly leveraged; in other words when their capital becomes too small relative to their assets. In such a case a relatively small decline in the quality of a portfolio can set alarm bells ringing that can lead to a run, with the consequent need to liquidate assets in fire-sale conditions. It is for this reason that minimum capital requirements are such an important part of prudential regulation. But excessive leverage is not a problem only for banks. It can apply to other financial institutions and, just as important, outside the financial sector.

When, as in many Asian countries, debt-to-equity ratios become very high, the companies concerned become excessively vulnerable to a re-evaluation of their profit prospects. A relatively small decline in asset values can wipe out equity, and thus lead to premature foreclosure by lenders. One of the most important lessons of the recent crisis is the need for non-financial corporations to hold higher levels of equity capital. It is tempting, of course, when profits are growing rapidly, to exploit the possibilities of leverage to increase the return on equity. Lending institutions, and their supervisors, have a responsibility to counteract this temptation by making sure that potential adverse scenarios are recognised and properly factored in to the pricing of risk.

One of the reasons why bank borrowing has played such an important role in financing investment in emerging markets is that bond markets are relatively underdeveloped in many of these countries. A key task is therefore to provide the necessary infrastructure and encouragement for the growth of long-term debt markets. It is good to note that several monetary authorities in the Asian region are now treating this as a matter of priority. Once such bond markets are established, they should prove attractive for corporate borrowers seeking to reduce their vulnerability to a liquidity crunch.

I have so far been speaking about lessons that borrowing countries can learn from the recent crisis. But there are also important lessons for those countries whose institutions contributed to the expansion and subsequent collapse of cross-border lending, as well as for the international community in its handling of the strains that can accompany greater international mobility of capital. Let me therefore turn to what the major creditor countries could do differently, before saying something about international arrangements more generally.

Banks in the major creditor countries have participated fully in the enthusiasm for investment in rapidly growing emerging markets. This already happened in the 1970s in Latin America, and led to the debt crisis that began in Mexico in 1982. As a result of that experience, banks were for a while much more circumspect. But by the 1990s they were already lending substantial amounts in Asia, buoyed by the perception that the Asian economies had better macro-economic fundamentals, including low inflation rates, modest public debt and very high rates of domestic saving and investment. This led lenders to overlook points of vulnerability. As we now know, a significant part of foreign lending went to over-leveraged companies and to financial institutions with weak balance sheets.

With hindsight, we can say that the lending banks made the crisis worse by first lending too much, and then withdrawing loans too precipitately. Both these problems must be tackled. In the first place, banks must be given the means and the incentive to make better lending decisions. Relevant information about the condition of borrowing institutions and countries must be made more transparently available; and banks must be encouraged to act on it by knowing that they will not be bailed out from bad lending decisions. Secondly, if a crisis does develop, ways must be found to reduce the tendency of private lenders to withdraw funds at the first hint of trouble.

Before concluding, I want to say something about international responses to the problem of strengthening financial stability. When a crisis develops, it is entirely appropriate that we use the mechanisms of international co-operation to help moderate and resolve the crisis. In practice, this involves a central role for the IMF, as well as for groupings of countries with a close interest in the speedy restoration of stability. But are there ways in which the international community could make its influence more effective? In other words, are there initiatives that can be taken at the international level that would help prevent crises, and resolve those that nevertheless occur in a more effective manner?

As I noted earlier, confident answers to these questions can only be given when we have a greater perspective on the reasons why the recent crisis occurred and spread. But certain tentative conclusions are already possible. In the first place, the international community can do a better job of establishing standards by which the various actors in international capital markets agree to be bound. These need to include standards of transparency with regard to relevant macroeconomic data and indicators of financial system soundness. Such data will facilitate assessment of conditions by domestic authorities, by market participants, and international institutions. Improved arrangements for surveillance, for example through peer reviews as agreed at Manila, can help alert domestic authorities to danger signals that may not be visible to them. I have already referred to the Core Principles of banking supervision. These will need to be elaborated in the coming months and years, and their implementation carefully monitored. Where necessary, countries that need help to come up to international best practice should receive technical assistance.

In addition to core principles of banking supervision, standards will be needed in other areas, such as accounting and disclosure practices for borrowers and lenders. Ways will need to be found to codify prudent behaviour in managing international borrowing and lending. In all of this, the more advanced financial centres will have to give a lead. In my judgement, it would be unacceptable for the industrialised countries to call for the adoption of standards in the emerging markets that they are not prepared to adopt themselves.

Concerning crisis resolution, one thing that is clear is that ever-larger official financing packages are not the answer. The key to successful crisis resolution is to restore the confidence of the private sector, without provoking moral hazard. This means finding ways in which the private sector is involved in crisis resolution from the start. The ideal is for private creditors to form committees that work out mutually agreed rescheduling packages with borrowers facing liquidity difficulties, as indeed happens in national jurisdictions. For the cases (hopefully small in number) where this does not work, ways will have to be sought that replicate at the international level the impact of insolvency procedures at the national level. In any event, the private sector cannot be allowed to simply await rescue by the international community.

Concluding remarks

I have tried to offer some preliminary thoughts on the lessons that we can draw from the events in Asia during the recent eight months. You and others are engaged in reviews from which we shall undoubtedly learn more. But a number of issues have emerged that need to be addressed if we are to avoid similar incidents in future. I have argued that expanded capital flows have not, by themselves, been the root source of the current crisis. However, to harvest the benefits they bring, action is required by domestic authorities and the international community in a number of areas. First and foremost, a premium needs to be placed on sustainable and responsive macroeconomic policies. In this regard, more critical examination of exchange rate policies, particularly in the light of accumulated foreign currency indebtedness, is needed. Second is the imperative of efforts to strengthen financial systems. There is now a core body of principles on which to draw which reflects the accumulated experience of supervisors and regulators in a variety of countries. Their implementation, both in industrial and emerging market economies, should be a matter of priority both for domestic authorities and the international financial community. Thirdly, there is a need to promote transparency to avoid excesses building up unnoticed. This will require improvements in accounting and disclosure practices and in international banking statistics, and an extension of data dissemination standards to cover domestic financial conditions. And, finally, as I noted at the end of my remarks, arrangements for crisis resolution need to involve burden sharing with the private sector to lessen moral hazard risk.

It would clearly be presumptuous to assert that by addressing these and other issues to be identified in due course, we shall avoid crises in the future, or handle more smoothly those that do occur. It would be equally hazardous to expect that there are ready and easy answers in several of these areas. I am confident, however, that the Asian economies struck by crisis will emerge strong and vigorous from the measures they are undertaking, and that the international community will be responsive to the lessons it has learnt from your experience.