

Mr. Greenspan's testimony on the international economic and financial system Testimony of the Chairman of the Board of Governors of the US Federal Reserve System, Mr. Alan Greenspan, before the Committee on Banking and Financial Services of the US House of Representatives on 16/9/98.

As I testified before this Committee in the midst of the Mexican financial crisis in early 1995, major advances in technology have engendered a highly efficient and increasingly sophisticated international financial system. The system has fostered impressive growth in world trade and in standards of living for the vast majority of nations who have chosen to participate in it.

But that same efficient financial system, as I also pointed out in that earlier testimony, has the capability to rapidly transmit the consequences of errors of judgment in private investments and public policies to all corners of the world at historically unprecedented speed. Thus, problems that appeared first in Thailand more than a year ago quickly spread to other East Asian economies that are relatively new participants in the international financial system, and subsequently to Russia and to some degree to eastern Europe and Latin America. Even long-time participants in the international financial community, such as Australia, New Zealand, and Canada, have experienced the peripheral gusts of the financial turmoil.

Japan, still trying to come to grips with the bursting of its equity and real estate bubbles of the late 1980s, has experienced further setbacks as its major Asian customers have been forced to retrench. Reciprocally, its banking system problems and weakened economy have exacerbated the difficulties of its Asian neighbors.

The relative stability of China and India, countries whose restrictions on international financial flows have insulated them to some extent from the current maelstrom, has led some to conclude that the relatively free flow of capital is detrimental to economic growth and standards of living. Such conclusions, in my judgment, are decidedly mistaken.

The most affected emerging East Asian economies, despite the sharp contraction in their economic output during the past year, have retraced, on average, only one-sixth of their per capita growth over the past ten years. Even currently, their average per capita incomes are more than 2½ times the levels of India and China despite the unquestioned gains both have made in recent years as they too have moved partially to join the international financial community.

Moreover, outside of Asia, several East European countries have made significant progress towards the adoption and implementation of market systems and have increasingly integrated their financial systems into the broader world context to the evident benefit of their populations. Latin American nations, though currently under pressure, have largely succeeded in opening up their economies to international financial flows, and more rapidly rising living standards have been the result.

It is clear, nonetheless, that participation in the international financial system with all its benefits carries with it an obligation to maintain a level of stability and a set of strong and transparent institutions and rules if an economy is to participate safely and effectively in markets that have become highly sensitive to misallocation of capital and other policy errors.

When domestic financial systems fail for lack of adequate institutional infrastructures, the solution is not to turn back to a less turbulent, but also less prosperous, past

regime of capital controls, but to strengthen the domestic institutions that are the prerequisite for engaging in today's international financial system.

Blocking the exodus or repatriation of capital, as some of the newer participants in the international financial system appear inclined to do after they get into trouble, is, of course, the equivalent of the economy receiving a subsidized injection of funds. If liquidity is tight, the immediate effect of controls can be relief from the strain of meeting obligations and a temporary sense of well-being. This is an illusion however. The obvious consequence of confiscating part, or all, of foreign investors' capital and/or income, is to ensure a sharp reduction in the availability of new foreign investment in the future.

The presumption that controls can be imposed temporarily, while an economy stabilizes, and then removed, gives insufficient recognition to the imbalances in an economy that emerge when controls are introduced. Removing controls subsequently creates its own set of problems, which most governments, inclined to impose controls in the first place, are therefore loathe to do. Indeed, controls are often employed to avoid required -- but frequently politically difficult -- economic adjustments. There are many examples in history of controls imposed and removed, but rarely without great difficulty and cost.

To be sure, any economy can operate with its borders closed to foreign investment. But the evidence is persuasive that an economy deprived of the benefits of new technologies, and inhospitable to risk capital, will be mired at a suboptimal standard of living and slow growth rate associated with out-of-date technologies.

It is often stipulated that while controls on direct foreign investment and its associated technology transfer are growth inhibiting, controls on short-term inflows do not adversely affect economic welfare. Arguably, however, the free flow of short-term capital facilitates the servicing of direct investments as well as the financing of trade. Indeed, it is often difficult to determine whether certain capital flows are direct investments or short term in nature. Chile is often cited as an example of the successful use of controls on short-term capital inflows. But in response to the most recent international financial turmoil, Chile has chosen to lower its barriers in order to encourage more inflows.

Those economies at the cutting edge of technology clearly do not need foreign direct investment to sustain living standards and economic growth. The economy of the United States in the 1950s, for example, needed little foreign investment and yet was far more dominant in the world then, than it is today.

That was a major change from our experiences of the latter half of the nineteenth century, when the vast amount of investment and technology from abroad played a significant role in propelling the US economy to world-class status.

Even today, though we lead the world in many of the critical technologies, we still need to borrow a substantial share of the mobile pool of world savings to finance our level of domestic investment. Were we unable to do so, our standard of living would surely suffer. But the inflow of foreign capital would be much reduced if there were uncertainties about whether the capital could be freely repatriated.

While historically there could be considerable risk in American investments -- for example, some nineteenth century investments in American railroads entailed large losses -- the freedom of repatriation and the sanctity of private contracts were, with rare exceptions, secure.

Our experiences, and those of others, raise the question of the sustainability of free international capital flows when the conditions fostering and protecting them are impaired or absent.

Specifically, an economy whose private and/or public sectors have become heavy net debtors in foreign currency is at risk of default, especially when its exchange rate unexpectedly moves adversely. Clearly, should default become widespread among a number of economies, the flow of international capital to other economies perceived as potentially in similar circumstances will slow and in certain instances reverse. The withdrawal of the ongoing benefits of free flowing capital, as recent history has so amply demonstrated, often can be abrupt and disruptive.

The key question is obviously how do private sector entities and governments and, by extension, economies as a whole allow themselves through currency mismatches to reach the edge of insolvency? Indeed, where was the appropriate due diligence on the part of foreign investors?

Investors will, on occasion, make misjudgments, and borrowers will, at times, misread their capabilities to service debt. When market prices and interest rates adjust promptly to evidence of such mistakes, the consequences of the mistakes are generally contained and, thus, rarely cumulate to pose significant systemic risk.

There was some evidence of that process working in the latter part of the nineteenth century and early twentieth century when international capital flows were largely uninhibited. Losses, however, in an environment where gold standard rules were tight and liquidity constrained, were quickly reflected in rapid increases in interest rates and the cost of capital generally. This tended to delimit the misuse of capital and its consequences. Imbalances were generally aborted before they got out of hand. But following World War I such tight restraints on economies were seen as too inflexible to meet the economic policy goals of the twentieth century.

From the 1930s through the 1960s and beyond, capital controls in many countries, including most industrial countries, inhibited international capital flows and to some extent the associated financial instability -- presumably, however, at the cost of significant shortfalls in economic growth. There were innumerable episodes, of course, where individual economies experienced severe exchange rate crises. Contagion, however, was generally limited by the existence of restrictions on capital movements that were at least marginally effective.

In the 1970s and 1980s, recognition of the inefficiencies associated with controls, along with newer technologies and the deregulation they fostered, gradually restored the free flow of international capital prevalent a century earlier. In the late twentieth century, however, fiat currency regimes have replaced the rigid automaticity of the gold standard in its heyday. More elastic currencies and markets, arguably, are now less sensitive to and, hence, slower to contain the misallocation of capital. Market contagion across national borders has consequently been more prevalent and faster in today's international financial markets than appears to have been the case a century ago under comparable circumstances.

As I pointed out before this Committee almost a year ago, a good part of the capital that flowed into East Asia in recent years (largely in the 1990s) probably reflected the

large surge in equity prices in most industrial economies, especially in the United States. The sharp rise induced a major portfolio adjustment out of then perceived fully priced investments in western industry into the perceived bargain priced, but rapidly growing, enterprises and economies of Asia. The tendency to downplay the risks of lending in emerging markets, reinforced by the propensity of governments explicitly or implicitly to guarantee such investments in a number of cases, doubtless led to an excess of lending that would not have been supported in an earlier age.

As I also pointed out in previous testimony, standards of due diligence on the part of both lenders and borrowers turned somewhat lax in the face of all the largess generated by abundant capital gains and all the optimism about the prospects for growth in the Asian region. The consequent emergence of heavy losses and near insolvency of a number of borrowing banks and nonfinancial businesses engendered a rush by foreign capital to the exits and induced severe contractions in economies with which borrowers and policymakers were unprepared and unable to cope.

At that point the damage to confidence and the host economies had already been done. Endeavors now to block repatriation of foreign funds, while offering temporary cash flow relief, have significant long-term costs and clearly should be avoided, if at all possible. I recognize that if problems are allowed to fester beyond the point of retrieval, no market-oriented solution appears possible. Short-term patchwork solutions to achieve stability are presumed the only feasible alternatives. When that point is reached, an economy is seen as no longer having the capability of interacting normally with the international financial system, and is inclined to withdraw behind a wall of insulation.

It must be remembered, however, that the financial disequilibria that caused the initial problems would not have been addressed. Unless they are, those problems will reemerge.

As I implied earlier with respect to the nineteenth century American experience, there are certain conditions precedent to establishing a viable environment for international capital investment, one not subject to periodic systemic crises.

Some mechanism must be in place to enhance due diligence on the part of lenders, but especially of borrowers individually and collectively. Losses of lenders do on occasion evoke systemic risks, but it is the failure of borrowers to maintain viable balance sheets and an ability to service their debts that creates the major risks to international stability. The banking systems in many emerging East Asian economies effectively collapsed in the aftermath of inappropriate borrowing, and large unhedged exposures, in foreign currencies.

Much will be required to bolster the fragile market mechanisms of many, but certainly not all, economies that have recently begun to participate in the international financial system. Doubtless at the head of the list is reinforcing the capabilities of banking supervision in emerging market economies. Conditions that should be met before engaging in international borrowing need to be promulgated and better monitored by domestic regulatory authorities.

Market pricing and counterparty surveillance can be expected to do most of the job of sustaining safety and soundness. The experience of recent years in East Asia, however, has clearly been less than reassuring. To be sure, lack of transparency and timely data inhibited the more sophisticated risk evaluation systems from signaling danger. But that lack itself ought to have set off alarms. As one might readily expect, today's risk evaluation systems are being improved as a consequence of recent failures.

Just as importantly, if not more so, unless weak banking systems are deterred from engaging in the type of near reckless major international borrowing that some systems in East Asia engaged in during the first part of the 1990s, the overall system will continue at risk. A better regime of bank supervision among those economies with access to the international financial system needs to be fashioned.¹ In addition, the resolution of defaults and workout procedures require significant improvements in the legal infrastructures in many nations seeking to participate in the international financial system.²

None of these critical improvements can be implemented quickly. Transition support by the international financial community to those in difficulty will, doubtless, be required. Such assistance has become especially important since it is evident from the recent unprecedented swings in currency exchange rates for some of the emerging market economies that the international financial system has become increasingly more sensitive than in the past to shortcomings in domestic banks and other financial institutions. The major advances in technologically sophisticated financial products in recent years have imparted a discipline on market participants not seen in nearly a century.

Whatever international financial assistance is provided must be carefully shaped not to undermine that discipline. As a consequence, any temporary financial assistance must be carefully tailored to be conditional and not encourage undue moral hazard.

It can be hoped that despite the severe trauma that most of the newer participants in the international financial system are currently experiencing, or perhaps because of it, improvements will emerge to the benefit, not only of the emerging market economies but, of the long-term participants of the system as well.

¹ Parenthetically, a century ago, banks were rarely subsidized and, hence, were required by the market to hold far more capital than they do now. In today's environment, bank supervision and deposit insurance have displaced the need for high capital-asset ratios in industrial countries. Many of the new participants in the international financial system have had neither elevated capital, nor adequate supervision. This shortfall is now generally recognized and being addressed.

² There are, of course, other reforms that I believe need to be addressed. These were outlined in my earlier testimonies before this Committee.