Mr Greenspan offers some suggestions to improve the international financial architecture

Testimony by the Chairman of the Board of Governors of the US Federal Reserve System, Alan Greenspan, before the Committee on Banking and Financial Services of the US House of Representatives on 20 May 1999.

Mr Chairman, Mr. LaFalce, and Members of the Committee, we at the Federal Reserve are in broad agreement with the approach outlined by Secretary Rubin, and expect to continue to work closely with the Treasury in this area.

As I have indicated previously before this committee, dramatic advances in computer and telecommunications technologies in recent years have enabled a broad unbundling of risks through innovative financial engineering. The financial instruments of a bygone era, common stocks and debt obligations, have been augmented by a vast array of complex hybrid financial products that has led to a far more efficient financial system. These same new technologies and financial products, however, have challenged the ability of inward-looking and protectionist economies to maintain effective barriers, which, along with the superior performance of their more open trading partners, has led, over the past decade, to a major dismantling of impediments to the free flow of trade and capital. The new international financial system that has evolved as a consequence has been, despite recent setbacks, a major factor in the marked increase in living standards for those economies that have chosen to participate in it.

Notwithstanding the demonstrable advantages of the new international financial system, the Mexican financial breakdown in late 1994 and, of course, the most recent episodes in East Asia and elsewhere have raised questions about the inherent stability of this new system.

These newly open markets were exposed to a huge expansion in capital inflows that their economic and financial systems were not ready to absorb. These flows in turn were engendered by the increasing diversification out of industrial country investment portfolios, augmented by huge capital gains through 1997. Net private capital inflows into emerging markets roughly quadrupled between 1990 and the onset of the Asian crisis. Such diversification was particularly directed at those economies in Asia that had been growing so vigorously through the 1970s, 1980s, and into the 1990s – the so-called “Asian tigers.” In the event, these economies were ill prepared to absorb such volumes of funds. There were simply not enough productive investment opportunities to yield the returns that investors in the West were seeking. It was perhaps inevitable then that the excess cash found its way in too many instances into ill conceived and unwisely financed real estate ventures.

What appeared to be a successful locking of currencies onto the dollar over a period of years in East Asia, led, perhaps inevitably, to large borrowings of cheaper dollars to lend, unhedged, at elevated domestic interest rates that reflected unheeded devaluation risk premiums. When the amount of such unhedged dollar borrowings finally became excessive, as was almost inevitable, the exchange rate broke.

While it might seem that the consequences were easily discernible, they were not. Problems with imprudently financed real estate investments emerge with chronic frequency around the globe without triggering the size of the collapse experienced in East Asia in 1997. The size of the crisis became evident only when the normal buffers that any economy builds up to absorb shocks were, in the case of the East Asian economies, so readily breached under pressure.

It has taken the longstanding participants in the international financial community many decades to build sophisticated financial and legal infrastructures that buffer shocks. Those infrastructures discourage speculative attacks against a well entrenched currency because financial systems are robust and are able to withstand the consequences of vigorous policy responses to such attacks. For the newer participants in global finance, their institutions, until recently, had not been tested against the rigors of major league pitching, to use a baseball analogy.

The heightened sensitivity of exchange rates of emerging economies under stress would be of less concern if banks and other financial institutions in those economies were strong and well capitalized. Developed countries' banks are highly leveraged, but subject to sufficiently effective supervision both by counterparties and regulatory authorities, so that, in most countries, banking problems do not escalate into international financial crises. Most banks in emerging market economies are also highly leveraged, but their supervision often has not proved adequate to forestall failures and a general financial crisis. The failure of some banks is highly contagious to other banks and businesses that deal with them, as the Asian crisis has so effectively demonstrated.

This weakness in banking supervision in emerging market economies was not a major problem for the rest of the world prior to those economies' growing participation in the international financial system over the past decade or so. Exposure of an economy to short-term capital inflows, before its financial system is sufficiently sturdy to handle a large unanticipated withdrawal, is a highly risky venture.

It thus seems clear that some set of suggested standards that countries should strive to meet would help the new highly sensitive international financial system function effectively. There are many ways to promote such standards without developing an inappropriately exclusive and restrictive club of participants.

For example, in any set of standards there should surely be an enhanced level of transparency in the way domestic finance operates and is supervised. This is essential if investors are to make more knowledgeable commitments and supervisors are to judge the soundness of such commitments by their financial institutions. A better understanding of financial regimes as yet unseasoned in the vicissitudes of our international financial system also will enable counterparties to more appropriately evaluate the credit standing of institutions investing in such financial systems. There should be no mechanism, however, to insulate investors from making foolish decisions, but some of the ill-advised investing of recent years can be avoided in the future if investors, their supervisors, and counterparties, are more appropriately forewarned.

To be sure, counterparties often exchange otherwise confidential information as a condition of a transaction. But broader dissemination of detailed disclosures by governments, financial institutions, and firms is required if the greater risks inherent in our vastly expanded global financial structure are to be contained. A market system can approach an appropriate equilibrium only if the signals to which individual market participants respond are accurate and adequate to the needs of the adjustment process. Product and asset prices, interest rates, debt by maturity, and detailed accounts of central banks and private enterprises are among the signals so essential to the effective functioning of a global economy. I find it difficult to believe, for example, that the crises that arose in Thailand and Korea would have been nearly so virulent had their central banks published data prior to the crises on net reserves instead of the not very informative gross reserve positions only. Some inappropriate capital inflows would almost surely have been withheld and policymakers would have been forced to make difficult choices more promptly if earlier evidence of difficulty had emerged.

As a consequence, the G-10 central banks and the IMF initiated an effort to establish standards for disclosure of on- and off-balance-sheet foreign currency activities of the public sector by countries that participate, or aspire to participate, in international capital markets. The focus of this work was the authorities' foreign currency liquidity position, which consists of foreign exchange resources that can be easily mobilized, adjusted for potential drains on those resources. This work was part of a larger effort to enhance disclosure of a broader set of economic and financial data under the IMF Special Data Dissemination Standard.

Such transparency suggests a second standard worth considering. Countries that lack the seasoning of a long history of dealing in international finance should manage their external assets and liabilities in such a way that they are always able to live without new foreign borrowing for up to, for example, one year. That is, usable foreign exchange reserves should exceed scheduled amortizations of foreign currency debts (assuming no rollovers) during the following year. This rule could be readily augmented to meet the additional test that the average maturity of a country's external liabilities should exceed a certain threshold, such as three years. This could be accomplished directly, or through the myriad innovations to augment maturities through rollover options. The constraint on the average maturity ensures a degree of private sector "burden sharing" in times of crisis, since in the event of a crisis, the market value of longer maturities would doubtless fall sharply. Clearly few, if any, locked-in holders of long-term investments could escape without significant loss. Short-term foreign creditors, on the other hand, are able to exit without significant loss as their instruments mature. If the preponderance of a country' s liabilities are short term, the entire burden of a crisis would fall on the emerging market economy in the form of a run on reserves.

Some emerging market countries may argue that they have difficulty selling long-term maturities. If that is indeed the case, their economies are being exposed to too high a risk generally. For too long, too many emerging market economies have managed their external liabilities so as to minimize their current borrowing cost. This short-sighted approach ignores the insurance imbedded in long-term debt, insurance that is almost always well worth the price.

Adherence to such a rule is no guarantee that all financial crises can be avoided. If the confidence of domestic residents is undermined, they can generate demands for foreign exchange that would not be captured in this analysis. But controlling the structure of external assets and liabilities nonetheless could make a significant contribution to stability.

Considerable progress has been made in recent years in developing sophisticated financial instruments. These developments create added complexity that all financial market participants, including policymakers from emerging market economies, must manage. However, they also create opportunities that emerging market economies should seek to exploit. In doing so there are lessons they can learn from advances in risk management strategies developed by major financial institutions.

To the extent that policymakers are unable to anticipate or evaluate the types of complex risks that the newer financial technologies are producing, the answer, as it always has been, is less leverage, i.e. less debt, more equity, and, hence, a larger buffer against adversity and contagion.

A third standard could be a legal infrastructure that enables the inevitable bankruptcies that will occur in today’ s complex world to be adjudicated in a manner that minimizes the disruption and contagion that can surface if ready resolutions to default are not available.

A fourth standard is the obvious necessity of sound monetary and fiscal policies whose absence was so often the cause of earlier international financial crises. With increased emphasis on private international capital flows, especially interbank flows, private misjudgments within flawed economic structures have been the major contributors to recent problems. But inappropriate macropolicies also have been a factor for some emerging market economies in the current crisis.

There are, of course, numerous other elements of sound international finance that are worthy of detailed consideration, but the aforementioned would constitute a good start. Even so, improvements in transparency, commercial and legal structures, as well as supervision cannot be implemented quickly. Such improvements and the transition to a more effective and stable international financial system will take time. The current crisis, accordingly, has had to be addressed with ad hoc remedies. It is essential, however, that those remedies not conflict with a broader vision of how our new international financial system will function as we enter the next century.