Comments on the

Third Hong Kong Monetary Authority Distinguished Lecture

given by

Monsieur Jean-Claude Trichet

by

Dr Don Brash
Governor
Reserve Bank of New Zealand

8 July 1999
HONG KONG

Thank you for giving me this opportunity to comment on M. Trichet's address. The subject of the address – "Risks and Challenges of the International Financial Scene" - is indeed a very topical and appropriate subject for the Hong Kong Monetary Authority Distinguished Lecture. And M. Trichet has raised a number of interesting points for me to comment on.

The Asian Crisis and other episodes of economic and financial distress have undoubtedly highlighted a number of vulnerabilities in the global economy. As a small and open economy, New Zealand has not been immune to the effects of regional and global financial distress, and we are mindful of the lessons that can be taken from it. My comments this afternoon are therefore made from the perspective of someone who is acutely aware of the potential vulnerability of small, open economies in a world of mobile international capital.

Financial crises are inherently complex and each one has its own unique causes and dynamics. I am therefore wary of generalising as to the factors that have contributed to the Asian Crisis. In the short time available to me, I will not attempt a comprehensive analysis. But I think a number of general observations can be made. This provides a basis for reflecting on the changes to international financial architecture that are required to reduce the risk and severity of future economic instability.

To me, there are four issues that particularly warrant policy attention:

- The risks associated with short term foreign capital – and particularly the risk of sudden and large capital outflows in response to perceived or actual deterioration in economic conditions and associated changes in market sentiment.

- The risks associated with pegged exchange rates. These risks include the potential fiscal costs of supporting an exchange rate perceived by the market as unsustainable, the potential for the exchange rate to become incompatible with other economic policy objectives, the risk of currency speculation and market manipulation, and the reduced incentives for exchange rate risk hedging.

- The implications of weak financial systems. We have seen that weaknesses in financial systems can place constraints on the maintenance of a pegged exchange rate, but can also create systemic instability and impose severe costs on the real economy when the currency is permitted to depreciate. And we have seen that weak financial systems can place substantial constraints on the availability of new credit and hence delay economic recovery.

- The risks of inadequate transparency. Lack of transparency, both in the public and private sectors, can exacerbate financial distress by reducing the scope for market disciplines to operate and by weakening the ability of creditors and investors to make informed decisions. In some cases, herd behaviour and resultant over-selling of currencies can be attributed in part to inadequate transparency.

What, then, can be done to address these problems and restore the global economy to sound health?

Before setting out some specific thoughts, I think a number of general points are worth mentioning:

- First, we should not pretend that risks can be *eliminated* or that we can create a world where financial distress does not occur. There will always be periods of financial distress.

No policy framework at national or international levels, will entirely eliminate these risks. And nor should we seek to do so. For we need to remind ourselves that there is always a trade-off between risk and return. If we seek to eliminate risks, not only will we be bound to fail, but we will also risk undermining the prospects for strong and sustainable economic growth. And, within reason, a degree of financial distress need not necessarily be a bad thing. The most we can hope to achieve is to reduce the risks and severity of economic distress in the future, and to create a resilience within economic structures to facilitate orderly recoveries from periods of distress.

- Second, we need to accept that modern economies are inherently complex and that there are no magic solutions. We need to be realistic as to what can be achieved. In that regard, I believe the best solutions will not lie in grand designs, but rather will be relatively modest and incremental in nature.

- Third, while some solutions may lie in changes to international financial architecture, I believe that the most productive remedies are generally those that apply at the *national* level – a point made strongly in an address given last month by Joseph Yam. There is a danger that the debate on the grander elements of international financial architecture could distract attention from the need for sound policy reform at the national level.

- And finally, we should not fall into the trap of placing excessive reliance on any one policy response. For example, financial regulation alone cannot provide all the solutions. And equally, improved transparency and market disciplines on their own will not be sufficient. The answer lies in striking a sensible balance among a number of mutually supportive policies. That balance will almost certainly vary from country to country. Hence, we should not seek to pursue a "once size fits all" type of approach.

Taking into account these general observations, I believe the most productive focus for international and national economic reforms lies in a few key areas:

- Strengthening financial markets.

- Reducing vulnerability to short term capital flows.

- Promoting greater transparency – at all levels.

- Involving private creditors in debt resolution arrangements.

As you will note, these four areas overlap significantly with some of the issues addressed by M. Trichet.

Let me elaborate a little on these points.

Strengthening financial markets. The importance of robust financial markets has been clearly demonstrated in many countries over recent years, most recently in Asia. Given the critical role that financial markets play in the wider economy, and the problems created when financial markets are in a weakened state, particularly in a world of mobile capital, it is essential that steps be taken to strengthen financial markets.

A number of positive measures are already being taken to this end. The development of the Basle Core Principles on Banking Supervision is one of these, as M. Trichet has mentioned. Effective banking supervision arrangements are clearly an important element in creating robust financial systems and the Basle Core Principles have the potential to play a helpful role in assisting governments to improve their supervisory arrangements. However, I would make two cautionary points.

First, it is important that the Core Principles do not become prescriptive, rigid templates to be applied uniformly in all countries. The optimal design of banking supervision arrangements will necessarily vary from country to country, depending on market structure, institutional arrangements and the effectiveness of market disciplines. It is important that, in advancing the Core Principles, governments have the leeway to depart from the specifics of the principles where they consider it appropriate to do so. And, in assessing compliance with the Core Principles, it is important that emphasis is placed on the quality of policy and policy outcomes, rather than on whether there has been strict compliance with the details of the Principles. This is also true for the other international standards being developed.

Second, it will not surprise you when I say that there are dangers in placing too much reliance on banking supervision, or in pursuing regulation with excessive vigour. Banking supervision and some regulation of risk-taking are important ingredients in the policy mix, but they are not sufficient in themselves to promote financial system stability. And there are dangers in taking regulation too far – we need to be sensitive to the compliance costs, regulatory distortions, moral hazard risks and potential impediments to financial innovation that can result from excessive or poorly designed regulation.

The essential partnership to banking supervision is the role market discipline can play in creating the right incentives for the sound management of banking risks. I believe that many governments have tended to under-estimate the importance of market discipline and that some government interventions have reduced the effectiveness of this discipline – to the detriment of banking system soundness. I would therefore urge policy-makers to take steps to strengthen market discipline in their economies. This can be done in a number of ways. An important step in this process is increasing the quality and frequency of disclosure made by financial institutions and strengthening the accountability of bank management and directors. In this regard, international initiatives to improve corporate governance and to strengthen financial disclosure and auditing arrangements are welcome developments.

A number of other measures can also be taken to strengthen financial markets – although some of these are not without controversy and do require political commitment. Possibilities include privatising or improving the governance arrangements for government-owned banks, improving the contestability of financial systems and, importantly, ensuring that financial safety nets and the strategies for addressing bank failures do not shield creditors from any possibility of loss.

Reducing vulnerability to short term capital flows. Short-term capital flows clearly played a major role in the Asian Crisis. In some cases, large capital inflows contributed to an overheating of asset markets and an excessive growth in credit, while shifts in market sentiment resulted in rapid capital outflows, with severe consequences for currency stability, liquidity and financial system soundness. It is obviously important that steps be taken to reduce the vulnerability of economies to the volatility of short-term capital flows, to the extent possible.

We live in a world of increasing capital mobility and I think we would all agree that the benefits this brings outweigh the costs. In particular, international mobility of capital strengthens the disciplines on policy-makers to maintain sound and credible policies, improves the efficiency of resource allocation and assists in economic development. Turning the clock back to a world of closed capital accounts is neither feasible nor desirable. But I think a number of measures can be taken to reduce the risks associated with short-term capital volatility.

- Adopting and maintaining sound, sustainable and credible macro and microeconomic policies is clearly essential. Although credible policies will not eliminate the risk of sudden capital outflows, they can be expected to assist in reducing volatility by creating a stronger basis for creditors and investors to make intelligent investment decisions and by improving investor confidence.

- The choice of exchange rate regime is also an important factor in determining an economy's vulnerability to short term capital flows. We have seen the dangers associated with pegged exchange rates – including the tendency for pegged rates to become inconsistent with economic fundamentals, the risk of currency speculation and the costs of holding the peg in the face of sudden capital outflows. Another danger is that pegged exchange rates reduce the incentives for financial institutions and corporate entities to hedge against foreign exchange risk, with predictable consequences in the event that the peg proves to be unsustainable. For these reasons, a new orthodoxy seems to be emerging on exchange rate policy. This thinking suggests that currencies should either be firmly anchored (for example, by way of a currency board arrangement such as that operated by Hong Kong) so that markets have confidence that the rate will be maintained, or that more flexible exchange rate regimes should be adopted.

  My own inclination is to think that there are advantages in countries adopting more flexible exchange rate regimes. Flexible exchange rate regimes offer a number of benefits, including promoting greater scope to pursue an independent, well focused monetary policy, reducing the risks of market manipulation and one-way bets, reducing the fiscal costs inherent in supporting fixed rates and sharpening the incentives for exchange rate risk hedging by government and private sector entities.

  This last point should perhaps be stressed. When banks and corporates know that the exchange rate is floating, and may move in either direction, the incentive to borrow heavily overseas is sharply reduced – or at the least, the incentive to hedge the risks associated with overseas borrowing is greatly increased. On this basis, when capital inflows become capital outflows, and the exchange rate falls, banks and corporates – and indeed governments – are much less likely to be seriously damaged.

- Where a fixed exchange rate is maintained, then another important element in reducing the risks associated with short-term capital flows is for a country to ensure that its holdings of reserves at least equal total short-term borrowings.

- The imposition of controls on capital flows – particularly capital inflows – has been an approach adopted by a number of countries to reduce capital volatility, with varying degrees of success. I would certainly not rule out the role that controls on capital inflows can play in reducing the volatility of capital flows or in altering the maturity composition of capital flows, particularly as a transition measure or when financial systems are weak. However, I must confess that I do have some serious reservations about them. In particular, I am mindful that capital controls are susceptible to evasion and that there is a risk of them becoming less effective as market participants become more adept at evading them. This is particularly so in a market where new derivative instruments are evolving rapidly and national boundaries are becoming increasingly less relevant. Moreover, capital controls can be expensive to enforce and have the potential to create undesirable distortions to resource allocation. I also believe there is a risk that controls on capital flows can reduce the incentives for governments to adopt and maintain sound and credible macro and microeconomic policies. It is for these sorts of reasons that New Zealand has rejected the use of capital controls.

Promoting greater transparency. The third key issue I have identified as a focus for national and international economic reform is transparency – a point made by M. Trichet. In my assessment, lack of transparency – in the public and private sectors – has been an important element in contributing to financial instability. I therefore endorse international initiatives to encourage greater transparency – at all levels within the economic community – including the transparency of the international financial institutions, national governments, central banks, government-owned corporate entities and the private sector. Greater transparency can be expected to increase the quality of economic policy and public and private sector decision-making, to sharpen the effectiveness of market discipline and to reduce the tendency for herd behaviour in currency and bond markets.

The development of international standards on transparency of fiscal, monetary and financial regulation policy by the IMF is a positive development in this context. Similarly, the development of disclosure principles by the Basle Committee on Banking Supervision and continued development of international accounting and audit standards will also be of assistance.

Involving private creditors in debt resolution arrangements. One of the important themes in the ongoing discussions on international financial architecture is the need to find ways to more effectively involve the private sector in international debt default resolution processes. This is a very important issue and one that warrants careful attention, as M. Trichet's address made clear.

Existing responses to international financial crises tend to either run the risk that some private sector creditors are insulated from loss as a result of rescue operations, or run the risk that debt defaults occur in a disorderly and damaging manner. Neither is satisfactory.

Insulating private creditors from loss, by bailing out sovereign or private borrowers, clearly weakens market discipline – both on the borrowers and the lenders. I have little doubt that this is one of the reasons why international lenders have, in some cases, under-estimated the risks associated with their lending, resulting in an inappropriate pricing of debt. As a result, borrowers have, in some cases, enjoyed access to an excessive level of credit and have not been as discerning as they might otherwise have been in determining how these funds will be applied. Involving private creditors in the resolution of debt servicing difficulties, and ensuring that they are exposed to their fair share of potential losses, are therefore important steps in creating an appropriate set of market disciplines on both lenders and borrowers.

However, it is equally important that this process does not lead to disorderly debt defaults. Defaults by debtors certainly help to instil market discipline, but they also risk significant disruption to financial markets and tend to impose higher costs on borrowers and lenders, as well as third parties, than might have been the case had the debt servicing difficulties been resolved in a more orderly manner.

A number of policies have been identified in the debate on this issue – some quite modest, and others rather ambitious. The issues involved are highly complex. Overall, I believe the most productive initiatives are those that involve relatively modest, practical solutions. In my assessment, the options that offer the greatest chance of implementation, and that warrant further detailed work, include:

- The adoption of majority voting clauses in loan documentation. This would facilitate negotiated solutions for the benefits of the majority of creditors and assist in achieving a more orderly workout process.

- Collective representation clauses, enabling a trustee to negotiate on behalf of creditors, might also assist in facilitating orderly resolution of debt defaults.

- Developing structures, such as standing committees of creditors, to facilitate better communication between creditors and debtors may also assist in reducing information gaps and initiating negotiations.

- Another important element, particularly in dealing with debt defaults by banks and corporate entities, is the development of appropriate insolvency laws at a national level, equipping national judicial systems to administer these laws and facilitating effective cross-jurisdictional enforcement.

Let me conclude by thanking M. Trichet for his address and for providing us with some new perspectives on issues relating to reforms of the international financial architecture. I am sure we can all agree that the issues are complex and that there are no easy solutions to be found. However, I am confident that discussions such as these, and the good work being carried out in many international fora, will lead to a better understanding of the causes and dynamics of financial crises and will provide the basis for developing appropriate policy responses. Thank you.