The US-Japanese Stake in a Free and Open Asian Capital Market

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Thank you. It is a pleasure to be speaking to such a distinguished audience on a subject that has been at the very forefront of all our minds in recent days.

Today, few would seriously doubt that in this new global economy, strong foreign and security relationships are built on strong economic ones. Nor, happily, would many doubt that the Joint United States-Japan Framework for a New Economic Partnership established in 1993 has helped us better understand the common ground that exists between our two countries and, critically, act on that agreement to achieve positive change.

While discussion of the global economy often emphasizes trade, in many ways it is finance, and its management for good or for ill, that shapes history. The financial problems of excess inflation or deflation have been at the root of some of the world's most profound conflicts. But in the latter decades of this century finance has also helped pave the way for one of the world's greatest successes -- the rise to modernity of countries where more than 3 billion people live, many of them in Asia.

The remarkable expansion in the volumes of capital flowing to developing countries that we have seen has opened up enormous opportunities for enhanced growth and living standards around the globe. But if we are to see this potential realized it will be critical to ensure that these flows of capital are as sustainable as they have been strong.

I. The lesson of history -- the need for liberal and open financial markets

It is sometimes argued that free financial markets are a recipe for short termism, sub-optimal growth and excessive vulnerability to external shocks. As an alternative, commentators have made prescriptions that favor less transparent arrangements and greater regulation. Indeed, it was not so long ago that it was common to suggest an Asian model for American finance, with industries relying to a much greater degree on financial institutions than on capital markets for their finance. In recent years, however, I think thinking -- as reflected, for example, in my friend Eisuke Sakakibara's remarks this morning -- has tilted firmly in favor a more open conception of financial markets.

Why? American experience. First, we have seen the renaissance of American business -- a renaissance that has given us more than five years of rapid growth in output and employment and low inflation, a renaissance that was rooted firmly in the competitive dynamism and openness of our

financial markets. It was supposedly impatient American capital that saw to it that major American companies were among the first companies worldwide to go through painful reengineering and restructuring to reflect competitive realities -- and, accordingly, saw to it that these companies emerged first, and strongest in their field. Equally, it is the openness of the American system that makes this venture capital industry able to look past the inexperience, the absence of a tie -- and see a potential Microsoft.

The second part of this experience has been experience dealing with the consequences of financial institutions' mistakes, such as in real estate speculation, which has taught the benefits of acting to unwind these mistakes as quickly and openly as possible, rather than allowing them to remain hidden in the hope that the difficulties will reverse themselves.

In the early years of the 1980s Savings and Loans Crises we learnt these lessons the hard way, when we allowed loss-making S&Ls to stay in business, and go for broke. That's exactly where they ended up. By contrast, the open revelation of the true extent of the problem -- as occurred after the creation of the Resolution Trust Corporation in 1989 -- is widely agreed to have signaled the beginning of the problem's end. In these and other cases, policy makers around the world have come to realize that illiquid and opaque markets find it harder to put these problems behind them -- and, relatedly, that bad news, openly confronted, is often less disruptive to ongoing market confidence than unpublicized, but widely suspected, bad news.

We've recently seen these lessons recognized in Japan, in the huge write-offs and provisions made by banks themselves, in legislation to strengthen the deposit insurance system, and in the creation last year of both a housing loans administration corporation and a resolution and collection bank to take over the assets and liabilities of failed institutions. We've also seen the new approach applied in the agreement, and progressive implementation of the 1995 United States-Japan Financial Services Agreement. And we've seen it in the announcement of a program of Big Bang Financial Reforms just under a year ago.

The Big Bang program speaks to Prime Minister Hashimoto's understanding of the critical role that a "free, fair and global" financial market will play in achieving the deep restructuring of the Japanese economic system that will be required to support a broad-based sustainable domestic recovery. Yet it is important to remember that a dynamic financial sector, and a dynamic economy, are mutually reinforcing goals. Japan will be far better placed to repair the health of its financial system and enjoy the benefits of a more liberalized financial system if along with financial reform its government is successful in pursuing policies to fulfill its commitment to domestic demand-led growth.

Here, as elsewhere in the government's reform programs, many of the details and implementation have still to be worked out. But, as Prime Minister Hashimoto recognizes, following through on these reform pledges will be vital to Japan's long term future. It will also send a powerful message to Japan's regional neighbors, and to others around the world, that reforms to make financial markets more liberal and transparent do not conflict with the task of restoring confidence to a troubled financial system -- they are essential to it.

II. Stable Finance for Emerging Markets

In a more closely integrated world, domestic financial problems become ever more closely linked with international financial problems -- and the domestic challenges of maintaining a healthy domestic financial sector become part of the broader challenge of ensuring financial stability internationally. Just as the slow-down in growth in the United States in the very early 1990s, and Japan's economic problems more recently, have highlighted the importance of healthy financial systems for continuing economic growth -- so events in Mexico and South-east Asia have underscored even more dramatically the need for sound finance.

Tolstoy once said that every happy family was happy for the same reasons -- but every unhappy family was miserable in its own particular way. Much the same might be said of financial crises: no one diagnosis ever quite fits all. That said, I think it is possible to identify four critical factors in the kind of emerging market problems we have seen.

1. Large-scale unmatched borrowing
As Federal Reserve Chairman Greenspan noted in his testimony before Congress last week, for much of the 1990s the newly industrializing South-east Asian economies enjoyed low inflation, rapid growth and ample liquidity. As has so often occurred in these conditions in the past, large amounts of investment flowed into a real estate boom -- investment in turn which ended up as collateral for a very large proportion of the assets of the domestic financial system. Text-books will make much of the distinction between investment and consumption in thinking about current accounts. But in this context, lending for conspicuous construction projects favored by local elites is much more like consumption than investment, and at least as likely to cause repayment problems.

2. ... poorly developed domestic financial systems
A second factor in these problems has been the underlying weakness of the domestic financial system. Lax lending standards, weak supervisory regimes and inadequate capital all help to permit large-scale imbalances to develop -- and to disguise their true extent when they do develop. As in Mexico, the very weakness of the financial system can further exacerbate the eventual crisis by discouraging prompt adjustment of monetary policy in the lead-up to the crisis -- and can also complicate the policy response after the crisis has begun. The one clear lesson, once again, is that a well capitalized, sound banking system is a national asset of immense value.

3. ... an unsustainable exchange rate regime
A third element is an unsustainable exchange rate regime. While the historical verdict on the merits of different kinds of exchange rate regimes is ambiguous, and while in different circumstances it is appropriate to have different kinds of exchange rate regimes, the lesson of Mexico, Thailand and other South-east Asian cases is not. It is that, in the presence of unsustainable current account deficits and a weak and over-extended financial system, rigid adherence to particular exchange rate without concomitant monetary commitment invites disaster.

The firmest supporters of fixed exchange rates will accept that they require the complete subordination of monetary policy to that single objective. This is a difficult to comply with when policy makers are mindful of the underlying weakness of the financial system. Increasingly they will be faced with a choice between raising interest rates to save the exchange rate peg -- or cutting interest rates to shore up the stability of the banking system. Too often, they can be paralyzed for so long that they fail to achieve either.

4. ... and the absence of strong and credible domestic institutions

And the fourth lesson, it seems to me, between these choices is confidence in core domestic institutions. Against such a backdrop, a change in one policy -- namely the exchange rate -- can lead markets to have doubts about the stability of the entire set of policies which had hitherto supported growth. The contrast in immediate effects as between the British devaluation of 1992, and the more recent Mexican case is instructive. The message is that if a nation's track record of basically sound government and policies is shorter -- and the underlying transparency and integrity of core institutions less well developed -- policy makers have to be that much more careful.

5. What did NOT cause these crises

Before moving to discuss the question of preventing problems and responses, let me take a moment to note some widely cited culprits I have *not* listed. Conspiracy theorists conjure pictures of hedge funds, like vultures, circling over the kill. But time and again, careful studies of the causes of financial problems -- such as the G10 study of the European currency crises and IMF analysis of the Mexican crisis -- have found that short term speculative flows were not the major source of the pressure on governments. By and large, the more appropriate image is of domestic investors losing confidence in their own country's currency and seeking to diversify their holdings, while at the same time medium and longer term foreign investors choose to lighten up, often in response to new information.

III. The Appropriate Domestic and International Response to Crises

There has been a great deal of discussion in Japan, in the United States, and around the world as to how best to respond to the crises which these problems can cause. These discussions will continue and need to include broader groups. But three core principles are: prevention, a strong domestic response by the countries concerned and, finally, international support.

1. Prevention: improving transparency and disclosure and surveillance both domestically and internationally

In many ways, the sources of these crises identify the core priorities in seeking a preventative cure. Fostering, in particular, the highest levels of transparency and disclosure in financial markets serves a dual purpose. To a far greater degree than other markets, the ability of financial markets to work efficiently in channeling resources to their most effective uses stands or falls by the quality of information available to market participants. And there is a further point, recalling Ken Galbraith's phrase that a "conscience is simply the fear that someone else might be watching", people are less inclined to behave imprudently -- not to say illegally -- if they know that their actions will in time be revealed.

I don't think there's any question that students of our financial system will judge that the emergence of generally accepted accounting principles did more for the long term health of the US financial system than Lockheed or any other bail-out. The special data dissemination standards (SDDS) developed by the IMF following the Mexican crisis have already made a significant contribution here. In Hong Kong the US urged the exploration of ways of expanding these standards to include forwards and derivatives, as well as more information on commercial banks, and encouraged their more widespread adoption. A particularly important area to address will be central bank accounting, where the traditional practice of reporting reserves without reporting forward transactions and other similar measures is akin to looking only at the assets and not the liabilities in a standard balance sheet.

More broadly, the international community needs to work to help countries develop the effective supervisory and regulatory systems, and strong legal and financial infrastructures needed to underpin a robust financial system. The Basel "Core Principles for Effective Banking Supervision", the end result of a United States-supported initiative launched in the summer of 1996, now provide a basis for countries to use to enhance the safety and soundness of their financial system. Similar standards for regulating securities firms are also in the pipeline.

But I think it is important in focusing on bank standards, that we don't just look at international bank standards. The focus be on developing a whole host of good habits and structures at the domestic level -- including the cultivation of a credit culture, effective supervisory bodies, and effective controls on self-dealing. I would highlight in particular the contribution that foreign participation can make. We have discovered in America that inter-state banking is more diversified and more stable -- in the same way, greater internationalization of finance can reduce risks at the same time as lowering the cost of capital.

2. A Strong Domestic Policy Response

As the experience in Mexico showed, a credible commitment to sound policies is the first and vital prerequisite for restoring stability. This cannot be overstated: credible monetary policies, sound fiscal policies and effective banking regulation. And in the atmosphere of distrust that defines these episodes, credibility has to be earned. To this day I am convinced that Mexico turned the corner with the markets the first time that an official forecast turned out to be overly pessimistic.

Governments must prove to the markets that they are committed to making the macroeconomic policy adjustments needed to put their economies back on a sustainable path -- and that they have the political will necessary to translate that commitment into actions. And they will need to make equally credible commitments to undertake reforms to strengthen domestic financial systems, and to work to develop effective and transparent supervisory and regulatory institutions, and strong legal and financial infrastructures to underpin those institutions.

There is always a temptation in the wake of financial turbulence to question whether it is driven by fundamentals, and to consider expansionary policy -- yes, expansionary policy -- to offset the adverse impact on domestic demand of financial problems, or at a minimum, to suggest that the orthodox adjustment policies are unnecessary. My reading of experience is that such counsel is unwise. It risks

excessive currency depreciation, and consequent damage to the financial system. It begets complacency. And keeping financial institutions afloat who have nothing to lose in further speculation may well push the long term costs of the eventual restructuring even higher.

3. Provision of international assistance
I have emphasized the issues of prevention and domestic response because I believe these to be at the center of a building a strong global capital market. But there will always be the question of what to do when crisis comes. The question of providing emergency financial support is a vexing one, and discussion of the right formulas and approaches will no doubt continue for a long time to come.

The problem has much in common with domestic lender of last resort issues. On the one hand, there is the problem of self-fulfilling prophesies -- a bank or nation will succeed if it is expected to succeed, and will fail if it is expected to fail. Credible and strong external finance can be the difference between a positive self-fulfilling prophesy and a negative one, as I believe was the case in Mexico. On the other hand, provision of finance inevitably carries with it moral hazards. It can make it less likely that healthy policies will be pursued, and more likely that risks will be run, and it may discourage investor scrutiny. It is critical that in a global capital market, investment flows are based on investors' perceptions of the underlying fundamentals of each country -- not the probability of some kind of international support.

The balance between these considerations is not easy to strike, and it is not clear it should be struck explicitly. Failing to plan is never right. But planning for failure carries risks as well. Governments may pay ransoms on occasion, but no government sets up a ransom fund to ensure they can do it efficiently.

The international community has traditionally looked to -- and will look to -- the International Monetary Fund as the critical provider of stabilization finance. Its unique ability to provide apolitical, conditioned finance in the context of, and only in the context of, strong reforms, makes it the appropriate vehicle for providing support when crisis comes. Of course, it is essential that we ensure that it has the financial means and modes to be most helpful.

With its recent Emergency Financing Mechanism, the establishment of the New Agreements to Borrow -- which we expect will soon take effect -- and the new quota arrangements agreed recently in Hong Kong, the IMF should be in an improved position to respond to crises. But I don't think any of us can rest on where we are. The difficulties in South-east Asia -- and the problems in emerging markets generally -- point up the urgent need for us to think about how we can best cooperate to maintain financial stability. This subject, with a primary focus on the Asian region, will be taken up soon in the forthcoming Manila meetings, and may well figure in APEC's discussions as well.

As we proceed it will be worth exploring ways in which countries' particular interest in assuring the stability of their close neighbors and trading partners might be brought to bear on these efforts -- for example, through regional surveillance arrangements. But financial regionalism based on regional reliance in times of crises also carries great risks -- of reducing the resources available for future

crises, of leaving the system less than well-prepared for cross-continental crises, of encouraging the importance of blocs, and of excluding nations who lack powerful neighbors. These are important parts of why we believe it to be essential that the IMF should play a central role.

There is no question that as we debate we will need to consider ways of giving a more effective voice to emerging economies, who have become such important global economic players. I look forward to constructive and active dialogue with these countries in Manila and in other fora in the months to come. Including these nations, particularly the strong, growing economies of Asia, will be critical to continuing the international community's program for ensuring that our financial architecture for ensuring global financial stability, as Secretary Rubin likes to say, "is as modern as the markets".

If the Mexican crisis of 1995 was the first 21st century financial crisis -- recent events in South-east Asia have perhaps presented us with the second such crisis. As has been true since that first crisis, the challenge for the international community going forward is to build a 21st century financial system to match.