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1. Shifting financial paradigms

As a member of the Administration, I spend a lot of time talking about our current exceptionally good economic performance. The economy is booming. The unemployment rate has declined to a level unseen since the 1973 oil shock, while inflation has remained tame. Investment is high, exports are strong, and consumers are confident. And we are well down the road to the first balanced federal budget since 1969.

Our strong performance coincides, unfortunately, with weakened economic performance by some of our international partners. This is particularly striking in Asia, where Japan is still recovering from a severe recession in the early 1990s. Even some other Asian economies, like Korea, Singapore, and Thailand, whose breakneck pace was undisturbed by the G-7 recessions of the early 1990s, slowed down in 1996, engendering an attack of economic angst.

We appear to have traded places with East Asia since 1990. Then, the Japanese and Asian economies looked unstoppable. It appeared in 1990 that Asia had discovered some secret for investment, growth, and economic performance that America lacked. This led to an examination of the many structural differences across the Pacific, and a focus on the benefits of the Asian system compared with the American system. The comparison extended to banking and finance. It is constructive to consider how and why views have changed since then.

Capitalism is broad enough to encompass competing models, including competing models of financial systems. The U.S. model -- shared with the U.K. and so sometimes called the Anglo-American model -- emphasizes arms-length market relationships. For example, it relies heavily on securities markets. To be sure, banks play an important role. But even bank loans tend to be made on arms-length terms. Certainly the government has little to say about where bank credit is allocated. The system that has developed in some Asian countries, on the other hand, has tended to follow more in the footsteps of the Japanese model. Without denying the important differences among these countries, the Asian systems traditionally seem to place greater reliance on bank loans than on securities markets, exhibit high debt/equity ratios, have closer relationships between banks and the companies that borrow from them, allow extensive corporate cross-shareholding, and feature greater guidance from the government in their credit allocation decisions. A common feature has been the imposition on banks of compulsory financing of certain activities in combination with repression of the rest of the financial system through, e.g., taxes on securities transactions. This is in some sense the classical Asian financial model. It probably best characterizes Japan thirty-forty years ago, and is a more up-to-date characterization of some other Asian countries.[1]

Germany and other continental European countries have their own systems, but in the emphasis on banking relationships versus securities markets, are more like the Japanese model than like the Anglo-American model. Of course this simple dual classification of the world's financial systems leaves out a lot. To take one example, Germany's universal banking system, which has spread to the rest of Europe and Canada, could be viewed as the antithesis of our Glass-Steagall law which segregates banking and securities. Yet Japan in this regard more closely resembles the U.S. in the respect that financial institutions are legally segregated by function. (This is no coincidence. Article 65 became law in 1948 under the influence of the American Occupation.)

[1] For references, see Frankel (1995).

Some five to ten years ago, economists were wondering if the Japanese system might not be superior to the Anglo-Saxon one. Research took both theoretical and empirical forms.[2] The theoretical models assumed asymmetric information (between borrowers and lenders). The idea is that, from the viewpoint of a firm seeking to finance an investment project, typical investors in the securities markets are strangers, who have no way of knowing whether to expect the firm's project to have as high a return as its managers claim. Such investors will demand a premium to compensate them. The statistical tests confirmed that firms were better able to finance their investment projects internally, than when they had to go to the securities markets and convince strangers of the worthiness of their projects. Relationship banking was thought to be a possible way around the asymmetric information problems that impeded capital markets. It was said that when a firm suffered a temporary setback, the short-sighted American financial system would cut it off from new funds, while Japanese banks had longer time horizons, and would give the borrower the resources to see it through.

The question ultimately was an empirical one. The Japanese system seemed to work very well. It produced miracle rates of investment and correspondingly high rates of growth. It was said to have helped provide Japan a low cost of capital, giving Japanese industry an advantage over American competitors. Versions of this type of finanical system in other Asian countries seemed to be working well also, in contrast to the recurrent crises in Latin America.[3]

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[2]Hoshi, Kashyap, and Sharfstein (1990a,b,c). Frankel (1993a) is a survey.

[3]Korea, for example, achieved remarkable growth rates. In a 1993 paper I allowed that "One should hesitate before condemning Korean 'financial repression,' given how successful the development process has been over the last thirty years (p.96)". But I did add "Nevertheless, it may be time to move on to a new stage." Now, four years later, I am prepared to conclude that it is indeed time for Korea to move on.

But now the much-vaunted Japanese financial system is looking tarnished. Precisely the attribute of the system that previously appeared to be a virtue, the willingness of banks to go on lending to firms in distress, now turns out to have led to serious problems. Borrowers who should have been cut off were not, with the result that further billions were lost. The public has had to pay twice. They pay once, in the form of slowed economic growth as the result of the prolonged overhang of bad loans (and other aspects of the burst bubble), and then again as taxpayers when the government ends up footing the bill.

Every country encounters bumps in the road. One does not want to conclude too much from a single episode. But I believe it fair to say that several aspects of the Asian model have been called into question recently, and that one of them is close relationships between banks and borrowers, and another is administrative guidance from the government.

East Asian financial systems appear to have been less able to withstand economic shocks than the U.S. system, even though the latter is far from perfect. Asian systems worked fine as long as economies grew fast and steadily. Problems arose when economies slowed or faltered. They include mounting bad loans, over-extended property markets, and some scandals. It hasn't helped when governments have wanted to paper over problems rather than addressing them squarely so as to put them in the past [By contrast, the U.S. financial system seems to have withstood shocks more readily, e.g., the 1990-91 recession, despite the earlier costly procrastination regarding the S&L problem.]

2. Increasing international focus on banking stability

In the last few years, the international focus on banking crises has increased. As with many other international economic phenomena, increased vulnerability to financial crises can be traced to two overarching trends that have swept the world: liberalization and globalization.

Governments everywhere have embraced market liberalization as the path to faster economic growth. This interest in liberalization stems from a wide consensus that the more statist models of development have failed. Governments worldwide have realized that to grow they must rely on markets. Goldsmith, McKinnon, and Shaw pointed out in the late 1960s and early 1970s the drawbacks of "financial repression," which both discourages the accumulation of saving and interferes with its efficient allocation. Since then, it has become widely understood that a liberalized, privately focussed financial system is a key element of a successful growth strategy. But as countries liberalize their financial systems, unconstrained financial institutions also have more scope for making potentially costly mistakes.

The second overarching trend is globalization. Globalization increases the international effects of domestic financial crises. Private capital inflows have grown in importance in the 1990s, and much of these flows are intermediated through domestic banking systems. This increases vulnerability to international shocks. Crises can be transmitted from one country to the next.

Some numbers illustrate the increase in private capital flows. In the eight years following the onset of the debt crisis in 1982, net private capital flows into developing countries averaged only $21 billion a year. Since 1991, however, total private capital inflows have climbed to an average of $146 billion per year. Portfolio capital flows have grown even faster, from $6 billion to $54 billion a year, more than a third of total flows. They tapered off somewhat after the peso crisis in early 1995, but hit a new high in 1996.

Volatile private portfolio flows can interact with liberalized banking systems to increase the likelihood of foreign exchange pressures. Domestic monetary policies must respond to these pressures, especially when a country is attempting to manage or peg its exchange rate. But to do this, monetary authorities must be able to raise interest rates temporarily. If the domestic banking system is already weakened by asset quality problems, raising interest rates will be more costly, and they will hesitate. This hesitation can increase speculative pressures against the exchange rate, leading to a full-fledged speculative attack. A weak domestic banking system was one element that made it difficult for Mexico to defend its peso in 1994.

3. Recent banking crises

There have been a number of prominent banking crises in recent years. Perhaps the first major one brought about by the current wave of liberalization was the U.S. savings and loan crisis in the 1980s, where a liberalized regulatory regime was grafted on to financial institutions with weak capital positions.

Severe problems also hit banks in some Nordic countries. Rules for these banks had been liberalized, while supervision had failed to keep up. When macroeconomic volatility hit these countries, banks became deeply insolvent, and state-takeovers ensued. State capital guarantees and capital injections ran as high as

8.2 percent of GDP, for Finland.[4] Clean-up costs have been even larger for banking problems in Spain.

[4]International Monetary Fund, *International Capital Markets: Developments, Prospects, and Policy Issues,* Washington, September 1994, p. 75.

In dollar terms, the banking problems that have plagued Japan since 1990 may represent the biggest financial crisis in recent history. The banking practices that looked so attractive in the 1980s proved to depend on a continuously growing economy. They also depended on a stock market bubble, which burst in 1990 with stock prices plunging more than 50 percent in two and a half years. By 1996, nonperforming loans in Japan reached 3.3 percent of total loans as officially reported by the major banks.[5] There have been signs that Japan's financial problems have lessened recently, in part because banks have begun to get their own houses in order. Nonetheless, a weak financial system appears to have exerted a drag on the Japanese economy in the last seven years.

Two years ago, we were reminded of the importance of banking systems in developing countries as well. After the peso crisis hit Mexico in December 1994, a weak banking system became a serious constraint on Mexican financial policy. The banking system had already been weakened by problem loans that mounted in the three years preceding the crisis. Nonperforming loans rose from 4 percent of total loans in 1991 to 8 percent in mid-1994.[6] Mexico also highlighted the issue of contagion. The peso crisis spread in the form of the famous "tequila effect" to other Latin American countries--especially Argentina and Brazil-- and even translated into foreign exchange pressures on some Asian emerging markets--including Indonesia, the Philippines, and Thailand--as well as some industrialized countries with weak economic fundamentals.

Recently our attention has also been drawn to banking problems in other countries. To name just a few, Korea is experiencing pressures on its banks in the aftermath of the bankruptcy of Hanbo. Russia and other transition economies are plagued by poorly managed banks, with incestuous relations among bank owners and

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[5]International Monetary Fund, *International Capital Markets: Developments, Prospects, and Key Policy Issues,* Washington, September 1996, p. 83.

[6] Goldstein (1997, p. 7).

bank borrowers. The Czech Republic and Thailand are also facing pressures.

The cost of banking crises has been severe in many countries. It has been estimated that resolution costs of banking crises in developing and transition economies have reached almost $250 billion since 1980. By one reckoning, there have been crises in 67 banking systems since 1980, and 52 of these have been in developing countries.[7]

4. Policy responses

The prevalence of banking and financial problems calls for policy makers to develop coordinated international responses. The right answer is certainly not to retreat from globalization or from liberalization, because these have both brought many economic benefits. I wonder if even the Greiders who warn of the dangers of the globalized marketplace truly want such a retreat.

Telling banks not to make bad loans is of limited practical use. Banks exist in part in order to make risky investments, and we should not expect them to have no bad loans. In an efficient, well-functioning financial system, banks should even fail occasionally. What we want out of a financial system is the ability to function efficiently, to support smoothly adequate levels of investment, and to withstand adverse economic shocks.

Elements of the financial system that appear to make it more resilient include: transparency, sound accounting practices, strong capital adequacy, and rules-based supervision. While acknowledging such failures as the savings and loan crisis, and without overselling the U.S. financial system, I would suggest that these are key elements of the American approach. We have in fact, made further moves in recent years to improve rules-based supervision and capital adequacy (e.g., “prompt corrective action”, though this rule has yet to be tested in a downturn).

Japan has also moved in this direction. The fact that different Japanese banks

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[7]Goldstein, p. 4.

now pay different borrowing spreads provides evidence that arms-length, market transactions are more prevalent in Japan than they used to be. Tokyo's "Big Bang" financial reforms will continue this trend.

International efforts to control banking risks go back to the Basle initiatives, starting in the 1970s. The original Basle Concordat laid down procedures for authorities to deal with international banking supervision, to address issues related to the Herstatt failure in 1974. More recently, Basle has provided a forum for bank regulators to coordinate on their capital requirements for international banks[8]. This helps level the playing field between banks in different industrialized countries, while also increasing the stability of these banks. The accord on capital to be allocated for credit risk has been followed by an accord on market-, interest-rate-, and foreign exchange risks.

The Basle initiatives generally were intended to cover only the participating industrialized countries. Importantly, they did not cover banks in developing or transition economies. As recent events demonstrate, emerging markets could benefit from more stringent rules. Such rules could also enhance international financial stability.

Morris Goldstein has called for the development of an "international banking standard," which lays down principles for bank regulation. We might call it the Goldstein standard. Emerging market countries that adopt the standard would reap the domestic benefits of a more stable and efficient financial system. They would also benefit from the increased confidence that international investors will have in their market.

Since the Halifax summit of the G-7 countries in 1995, the United States has encouraged efforts -- more or less along these lines -- to improve financial stability in emerging markets. In the past year, the industrialized members of the Basle Committee on Banking Supervision, which includes the United States, have worked with developing countries to put in place a framework for financial stability, in the form of a set of "core principles of effective banking supervision." Representatives of G10 and non-G10 economies also organized a working party, which issued a report in April detailing key elements of a robust financial system. The principles included a proper legal framework, adequate accounting principles, a strong payments and

[8]International Monetary Fund, 1996, p. 141.

settlement system, high quality and timely financial disclosure, effective risk management and internal controls, and capital sufficient for the risks taken.[9] The report also laid out an international strategy to promote financial stability, a strategy that has been endorsed by the G10 Ministers and Governors, and is expected to receive a further push at the Denver Summit.

Last week, the Group of Thirty previewed another proposal. It is based on the idea that globally active financial institutions should get together and develop standards for how their businesses can be run safely. This international self-regulation could potentially complement current efforts to coordinate national regulatory regimes. Also relevant is a recent report from a task force of the Institute for International Finance. We welcome these private sector initiatives, not to mention work at the International Monetary Fund, Bank for International Settlements, and other international organizations.

5. Conclusion

It has been suggested that Mexico was the first financial crisis of the twenty-first century. If the current initiatives bear fruit, however, we can hope to limit the frequency and magnitude of financial crises in the coming century. With increasing international economic interdependence, and the prosperity that comes with it, it is important to insure that the 21st century sees a minimum of such disruptions. The United States and its international partners are working to strengthen the stability of domestic financial systems, in order to contribute to continued international financial stability.

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[9] *Financial Stability in Emerging Market Economies,* April 1997.

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