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Statement by
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The crisis in emerging market economies that began in Thailand a little over a year ago, spread to other economies in East Asia and Russia, and has most recently been pressuring a number of economies in Latin America. There is little evidence to suggest that the contagion has subsided.

Moreover, the declines in Asian export markets only added to the difficulties in Japan, which was struggling with a preexisting set of corrosive banking problems. Those difficulties have contributed to that economy's most protracted recession in the postwar era.

As I indicated several weeks ago to a university audience, it is just not credible that the United States, or for that matter Europe, can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress.

With few signs that the financial crisis that started in Asia last year has subsided, or is about to do so, policymakers around the world have to be especially sensitive to the deepening signs of global distress, which can impact their own economies.

In emerging markets, after about six months of relative stability, heightened perceptions of credit risk erupted in mid-August when Russia, which seemed to have been making progress toward greater stability, fell into renewed crisis.

Russia is not large in the world's trade accounts or critical to the stability of the international financial system. Nevertheless, the severity of its crisis and the authorities' inability to contain it reflected a significant jump of contagion out of East Asia, which, until then, had been assumed to have gone into remission.

The shock drove yields on dollar-denominated debt securities of emerging market economies sharply higher across the globe, engulfing economies that are as radically different as Korea, Brazil, Poland, South Africa, and China. To be sure, some yields have increased only one

to two percentage points, while others have risen ten points or more. But all these economies have experienced stress. The flight to safety has significantly augmented the demand for U.S. Treasury securities, whose yields have declined in tandem with the increases in yields on most dollar-denominated sovereign debt in international bond markets.

In recent weeks, that shift internationally has also been accompanied by a rising concern for risk in the United States, presumably reflecting the fear that the contagion would adversely affect our economy.

When I testified before the Congress in July, I noted that some of the effects of the international crisis had actually been positive for the U.S. financial markets and economy, for example, by lowering long-term interest rates paid by our households and businesses. However, the most recent more virulent phase of the crisis has infected our markets as well. Concerns about business profits and a general pulling back from risk-taking in the midst of great uncertainty around the globe have driven down stock prices and pushed up rates on the bonds of lower-rated borrowers. Flows of funds through financial markets have been disrupted, at least temporarily. Issuance of equity, and of bonds by lower-rated corporations, has come virtually to a halt, even investment-grade companies have cut back substantially on their borrowing in capital markets. Banks also are reportedly becoming more cautious and more expensive lenders to many companies.

There is little evidence to date, however, that foreign problems or the tightening in financial conditions in domestic markets have produced any significant underlying weakness in the American economy as a whole. Moreover, labor markets remain tight and hourly compensation has continued to grow more rapidly. Nonetheless, the increases in overall costs

and the CPI have been held to modest levels by reasonably good productivity advances, lower oil prices, and foreign competition

However, looking forward, the restraining effects of recent developments on the U S economy are likely to intensify. As I noted in congressional testimony last week, we can already see signs of the erosion of production around the edges, especially in manufacturing. Disappointing profits in a number of industries and less rapid expansion of sales suggest some stretching out of capital investment plans in the months ahead. Lower equity prices and higher financing costs should damp household and business spending, and greater uncertainty and risk aversion may also lead to more cautious spending behavior.

When I testified on monetary policy in July, I explained that the Federal Open Market Committee was concerned that high--indeed rising--demand for labor could produce cost pressures on our economy that would disrupt the ongoing expansion. I also noted that a high real federal funds rate was a necessary offset to expansionary conditions elsewhere in financial markets. By mid-August the Committee believed that disruptions abroad and more cautious behavior by investors at home meant that the risks to the expansion had become evenly balanced. Since then, deteriorating foreign economies and their spillover to domestic markets have increased the possibility that the slowdown in the growth of the American economy will be more than sufficient to hold inflation in check.

As I have indicated in earlier presentations, the dramatic advances in computer and telecommunications technologies over the last decade have fostered a marked increase in the degree of sophistication of financial products. A vast new array of debt, equity and hybrid instruments, as well as newly crafted derivative products have fostered an unbundling of risks,

which, in turn, has enabled investors to optimize (as they see it) their portfolios of financial assets. This has engendered a set of market prices and interest rates that have guided business organizations increasingly toward producing those capital investments that offer the highest long-term rates of return, that is, those investments that most closely align themselves with the prospective value preferences of consumers. This process has effectively directed scarce savings into our most potentially valuable productive capital assets. The result, especially in the United States, where financial innovations are most advanced, has been an evident acceleration in productivity and standards of living, and, owing to the financial sector's increased contribution to the process, a greater share of national income earned by it over the past decade.

The new financial innovations, which have spread at a quickened pace, have facilitated a rapid expansion of cross-border investment and trade, and almost surely, as a consequence, a significant increase in standards of living for those nations that have chosen to participate in what can appropriately be called our new international financial system. The system is new in the sense that its dynamics appear somewhat more accelerated relative to the international financial structure of, say, fifteen or twenty years ago. Owing to the newer technologies, market prices have become more sensitively tuned to subtle changes in preferences and, hence, react to those changes far faster than in previous generations. The system is productive of increased standards of living and more sensitive to capital misuse. It is a system more calibrated than before to not only reward innovation but also to discipline the mistakes of private investment or public policy.

Thus, the crises that have emerged out of this new financial structure, while sharing most of the characteristics of past episodes, nonetheless, appear different in important ways. It is not yet clear whether recent crises are deeper than in the past, or just triggered more readily.

In early 1995, I characterized the Mexican crisis as the first crisis of this new international financial system. The crisis that started in East Asia more than a year ago, is its second.

Since the Mexican crisis, policymakers have been engaged in an accelerated learning process of how this new system works.

There are certain elements that are becoming evident.

The sensitivity of market responses under the new regime has been underscored by the startling declines of exchange rates of some emerging market economies against the dollar, and most other major currencies, of 50 percent or more in response to what at first appeared to be relatively modest financial difficulties. Market discipline appears far more draconian and less forgiving than twenty or thirty years ago.

Capital, which in an earlier period may have flowed to a "merely adequate" profit environment, owing to a lack of information or opportunity, now shifts predominantly to those ventures or economies that appear to excel. This capital, in times of stress, also flees more readily to securities and markets of unquestioned quality and liquidity.

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 vigorous policy responses to such attacks. For the more recent 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 situation in many emerging market economies is illustrative. Under stress, fixed exchange rate arrangements have failed from time to time. Consequently, domestic currency interest rates, reflecting devaluation probability premiums, are almost always higher in emerging market economies with fixed exchange rates than in the economy of the major currency to which the emerging economy has chosen to peg. That currency is often the dollar.

This phenomenon, and its risky exploitation, is one important element in the current crisis and a symptom of what has gone wrong generally. What appeared to be a successful locking of currencies onto the dollar over a period of years in East Asia and elsewhere, led, perhaps inevitably, to large borrowings of cheaper dollars to lend at elevated domestic interest rates, with the intermediary pocketing the devaluation risk premium. When the amount of unhedged dollar borrowings finally became excessive, as was almost inevitable, the exchange rate broke. Incidentally, it also broke in Sweden in 1992 when large borrowings of DM to lend in krona at higher interest rates met the same fate. Such episodes are not uncommon, suggesting that investors, even sophisticated ones, are prone to this type of gambling.

This 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 so that, in most countries, banking problems do not escalate into international financial crises. Most banks in emerging nations 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.

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 standards for participation in the new highly sensitive international financial system is essential to its effective functioning. There are many ways to promulgate such standards without developing an inappropriately exclusive and restrictive club of participants.

One is far greater 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 is 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 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.

I must also stress 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.

Improvements in transparency, commercial and legal structures, as well as supervision that I, and my colleagues, have supported in recent months 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, will have 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.