Speeches

A Federal Reserve View on Credibility in Monetary Policy and Bank Supervision

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Good morning! This is my first time to participate in a meeting of the Bankers' Association for Foreign Trade, and I very much appreciate your invitation to speak on "The View from the Federal Reserve." This morning, I'd like to kick off the day by sharing a Federal Reserve view on international banking supervision and regulation and, in particular, to do so with a special focus on Latin America. The reason I plan to focus on this part of the world is because some time after the Foreign Bank Supervision Enhancement Act (FBSEA) was enacted in 1991, the Fed's Board of Governors decided to have different Reserve Banks specialize in different areas of the world so that, as a System, the Fed could develop more depth of knowledge and understanding with regard to the financial and banking systems of various countries. The idea was that all Reserve Banks could then make use of this expertise in dealing with banks or supervisory matters in a particular region.

The Atlanta Fed was assigned most of Latin America and the Caribbean as our specialized areas. We were a natural for that assignment, since Florida, which is one of the states in our District, does a tremendous amount of trade with Latin America. Miami is often referred to as the "Gateway to Latin America," and, in fact, every time I visit our branch office in Miami, I'm struck by how Brickell Avenue looks like the center of the universe for the many international banks located in south Florida that focus their business on Latin America and the Caribbean.

The main points I'd like to make today revolve around the issue of credibility. Countries seeking to promote economic development and sustainable growth need to have a set of public policies in place that warrant credibility. Since the late 1980s, Latin American countries have paid considerable attention to putting into place credible macroeconomic policies. They seem to have learned the lesson that you can't "jump start" economic growth--at least not sustainable growth--with excessively stimulative fiscal or monetary policy. Having achieved considerable progress toward reining in inflation and bloated public sectors, the next area that, in my opinion, deserves more attention is credible policy at the microeconomic level, especially in the area of banking.

In particular, I would like to suggest that there's much to be gained from policies that encourage the development of a strong, independent bank supervisory system in order to foster a healthy, dynamic banking system. This focus is especially warranted in view of the fact that banking systems in Latin American countries are, to a large extent, emerging from a period of considerable public intervention and direction. Moreover, there are fewer alternative institutions that can serve as a source of financial intermediation and market discipline compared with the broad array of highly liquid financial markets that exist in many industrialized countries. So, my theme for the day is that without credibility--credibility in fiscal policy, credibility in monetary policy, and, importantly, credibility in supervision of the banking system--it will be more difficult to achieve and sustain the rate of economic growth that I believe all countries desire. I'll also leave you with some food for thought about the role of the central bank in all of this.

Progress in Latin America

Let me begin by talking briefly about the progress we've seen in Latin America. As a region, Latin America continues to enjoy a meaningful economic recovery from a ten-year period, often called the Lost Decade of the 1980s. During these years, economic stagnation, accelerating inflation (and, in some cases, hyperinflation), and net capital outflows plagued many countries of the region. In contrast, the consensus forecast for Latin America in 1997 is for a more than 4 percent rise in the gross domestic product for the region as a whole, building on about a 3-1/2 percent rate of growth regionally last year. That growth rate may not sound all that exciting for a developing economy, and, indeed, it's not high enough to raise living standards significantly on a per capita level. It does suggest a positive resilience in these economies in the wake of the 1995 peso crisis and the ensuing repercussions in many other Latin American economies. However, to raise per capita living standards, these emerging market economies need to sustain higher real rates of growth.

Much of this growth is attributable to macroeconomic reforms and market-oriented structural reforms that have been introduced in many Latin American countries. Deficit reduction, more credible monetary policies, a reduction in trade barriers, and privatization of state-run enterprises are being successfully implemented in many countries of the region. These policies were not only instituted but also maintained--sometimes with great effort. For example, to achieve the sharp disinflation that we've seen and to establish credibility in the monetary policy area, certain countries have subjected themselves to enormous discipline: one need only think of Argentina's willingness to peg its currency, that is, to subject itself to the externally driven discipline of a currency board, in order to curtail its hyperinflation. However, these desirable economic stabilization measures don't come without transition costs that are very real for the people experiencing them, and here I'm thinking of the civil unrest we've seen in Venezuela and Mexico. Overall, though, I think there's reason to believe that the economic outlook for Latin America is brighter than ever before.

We've also seen a lot of progress in the banking systems of the region. The Atlanta Fed's role in international banking supervision for Latin American and Caribbean banks that have existing offices in the United States or that wish to set up offices here has given us the chance to get to know the banking systems in these countries better. In the process, we've also become more familiar with their regulatory framework as well as the larger financial and economic systems in which they function. This understanding is being developed, in part, through the gathering of statistics and information as well as formal analysis. In addition, we are working hard to create partnerships with our central bank and supervisory counterparts in each of the countries we follow. The latter actually goes back a number of years, but it was intensified beginning in 1989 when our top international people began making regular visits to many Latin American countries in order to open lines of communication. Since then, we've been participating in training efforts throughout the region to discuss the Federal Reserve's methods of supervision.

Overall, I'm pleased with the level of understanding we've been able to reach with our counterparts--and I hope they are as well. Last October, I personally went to visit central banks and supervisory authorities in Chile, Argentina, and Colombia. While there, I met with Mr. José Florencio Guzman in Santiago. He is the superintendent of banks and financial institutions in Chile. He also happens to be the chairman of the Association of Supervisory Authorities of Latin America and the Caribbean. Two months later in December, he was at our Miami branch for a meeting that we hosted of the board of directors of that association. That's just one small

example of how we are trying to work jointly with our policy counterparts.

Having served as the head of our Bank's supervision and regulation function at an earlier stage of my career, I personally know what kinds of challenges arise in an environment of rapid change, even when the change is positive from a macroeconomic perspective. (My tenure in that job occurred during a time of high inflation and then pretty rapid disinflation.) Given that "hands-on" experience, it's my judgment that the work being done to improve the quality of banking supervision in Latin America is most commendable.

Challenges That Remain in Latin America

But not all the challenges have been met, especially if the ultimate goal of higher living standards for all citizens is to be achieved. I'd like to talk about three that still await some real progress. The first one I'll mention--the need for domestic savings--comes directly from Mexico's president, Ernesto Zedillo, who came to speak at the Atlanta Fed at a luncheon we hosted just last week while he was in Atlanta for the Latin America Conference at the Carter Center. Simply stated, one of his main messages to our audience was that a country can do everything right--that is, enact privatization, trade liberalization, and other market-oriented policies--but if it forgets about domestic savings, then these policy reforms will not work. He went on to talk about the changes the Mexican government has made to raise the VAT to discourage consumption and to introduce a new individualized pension system to foster savings.

In my own opinion, the most fundamental condition necessary to foster domestic savings--and I admit to a certain prejudice here as a central banker, but I do believe it strongly--is an environment of low and steady inflation, and sustaining these kinds of economic conditions requires credibility in monetary policy. At the same time, the effect of credible macroeconomic policies on savings can probably be enhanced by advances in two other areas that have not received enough attention to date.

One is private property and contract law. Well-defined, defensible, and generally recognized property rights are part of the rule of law. At the same time, they are part of the environment of credibility that is so critical to sustainable economic growth in a market economy. Without this element, private and corporate citizens will continue to fear nationalization and operate as though the government could take their property at a moment's notice. This very real fear of enforced nationalization, along with fears of high and volatile inflation, has been a key factor underlying the extremely complex pattern of offshore holdings that developed in many Latin American countries and most particularly among the banking organizations in the region. With wealth being held outside the country, domestic investment and, in turn, growth have been constrained from what they might have otherwise been.

The other large hurdle yet to be fully cleared is the establishment of an independent supervisory and regulatory framework for banks. As I indicated a few minutes ago, I'm encouraged that many Latin American countries have begun to overhaul outmoded banking laws to bring their banking systems more in line with international standards of regulation. I'm particularly encouraged by developments in Colombia, Chile, and Argentina, for example, and the direction set by new banking laws in Peru. But now comes the hard part--making sure that the laws are being implemented and persuading citizens to trust that their banks are safe and sound. Again, credibility is the key.

Why All Countries Need a Sound Banking System

Let me take a moment to go into my rationale as to why any country needs to have a sound banking system with independent supervision and regulation. Now, as bankers, you don't need to be convinced that credit intermediation is a vital function if savings are going to be funneled to their most productive use. Nor do you need to be convinced that banks traditionally play a vital role in this process. This is particularly the case in developing countries, where there are often not a large number of financial institutions and where alternatives are not as readily available as they are in, say, the United States. I won't waste time by preaching to the choir on this point.

Let me instead talk about an area where I may have a bit of an edge in terms of familiarity, namely, monetary policy. A sound banking system is critical for credible monetary policy, most especially in developing countries--where there are few alternatives, such as capital markets--and in emerging market economies, where, until recently, many banking institutions may have been subject to public control or considerable influence. In this setting, a weak banking system can inhibit monetary policy, particularly if a country has been running a fairly loose monetary policy. In this context, when the decision comes to tighten--to apply the brakes and raise real rates--banks that have been counting on the central bank to keep credit fairly loose may simply not make it through the changed circumstances, and this can spell disaster if there aren't very many banks to begin with.

Even countries that try to achieve credibility by pegging their currency may find that, if there's a run on their currency, the banking system may collapse under the weight if it is not sufficiently prepared to weather such a run. The upshot is that if people (read "speculators") guess that the banking system could collapse while the country is trying to bring down high inflation through monetary policy or through pegging, then the country won't be able to stick with its new policy.

Another reason for a strong banking system is related to something I mentioned earlier--that increasing domestic savings is an important goal for economic growth. It bears repeating that the credibility of macroeconomic policies is critical: fiscal and monetary policy must give savers and investors the assurance that their funds will not be devalued by the ravages of inflation. In addition, it certainly wouldn't hurt the goal of increasing domestic savings--and it probably would help--to have a safe banking system.

Now I'm sure I haven't said anything so far that is very controversial from your perspective. Everyone in this audience should be an advocate of a strong banking system. Where we may differ is that I believe a strong and independent bank supervisory system is critical to the health of the banking system. This would be particularly true for countries where there are few alternatives and where the banking institutions themselves are emerging from a period of substantial government intervention in the process of credit intermediation.

Over the years, we've seen too many examples in Latin America of inadequate bank supervision. Lax oversight enables a host of bad banking practices. These circumstances, in turn, put enormous pressures on a country's public policy institutions. We've seen in Venezuela most recently how the policy response to a cascading set of problems in the banking system was to allow enormous inflation and a bailout that dwarfs our own savings and loan crisis in the United States. Perhaps Venezuela's monetary authority should have stood firm against this pressure, but the result might well have been a deep recession or depression.

I'm not suggesting that strong bank supervision alone will create a strong banking system and bolster savings, but with stronger supervision, a stable currency, and a stable banking system, Latin American countries may find that their citizens are more interested in keeping their savings in their home countries and investing in local businesses to create more vibrant market economies. Those of us who live in industrialized economies take these aspects of a sound banking system--and the role of

the regulatory structure--for granted. However, there's a huge public benefit arising from the fact that, as consumers, we can absolutely trust our banking system to be sound and not many of us lose sleep over whether our deposits are safe. I like to think of it as infrastructure or an investment in trust and credibility. Just as the construction of ports and highways is important for economic development, so is a sound bank regulatory system.

Who Should Perform Bank Supervision?

The question becomes then, who should perform bank supervision? I would argue that there are certain standards for who should be performing bank supervision. In the first place, it should be an entity that is independent of the political process. Political independence for an organization that is overseeing the financial system is the very best way to engender trust in the system. An independent supervisor allows for consistent supervision, even if it's an election year.

It's also important that this politically independent body have a balanced view of the role of banks in society, unlike some governments that tend either to act as if the banks were an extension of the finance ministry or to use banks as an economic development vehicle by mandating lending to chosen industries. The supervisory body must be able to balance its responsibility to prevent major financial market disruptions with its responsibility to ensure that private sector institutions have the capacity to take prudent and appropriate risks. In other words, it wouldn't be practical for a regulator to decide that zero risk was the appropriate measure of financial safety and soundness because banks are in the business of taking risks to leverage their assets.

Different Ways to Do Supervision

Now, if we take a look around the world, we can find different ways to put a sound supervision and regulation system in place. Some countries generally combine monetary policy and bank supervision. These include France, Italy, the Netherlands, New Zealand, the United Kingdom, and the United States, among others. Other countries generally keep monetary policy and bank supervision separated. These include Denmark, Germany, Japan, Mexico, and Switzerland, among others. There are arguments for either model, combining or separating, but since I know the U.S. system the best, let me describe why we believe the central bank needs not only to be responsible for monetary policy but also to play a significant role in bank supervision.

In the United States, the goals that have been mandated by Congress for the central bank include achieving sustainable economic growth, price stability, and full employment. Monetary policy is implemented through the banking system by changing the amount of reserves. Since we use the banking system to put our monetary policy in place, we have a strong vested interest in the safety and efficiency of that industry. What we want to avoid is a situation in which good monetary policy can't be implemented in the economy at large because the intermediaries aren't efficient.

Here in the United States, the Federal Reserve, as the central bank, also has the lender-of-last-resort role. As such, we find it necessary to know the operations of the banking system firsthand. That means we want to see what's going on with the balance sheets of banks, their practices, assets, risk management, etc.

In essence, the Fed is providing an insurance policy to American businesses and consumers, an insurance policy against disorderly and unstable financial markets. You need only think of the kinds of financial panics that used to occur with some regularity before the Fed was established to understand what I'm talking about. But, as an insurer, we must satisfy ourselves--and the American taxpayers--that we're not indirectly allowing banks that might seek to borrow through the discount window to engage in the very activities that would lead them to seek such an extreme remedy.

Those arguments speak to why banking supervision is critical to the Fed. But how about turning that around and asking why the Fed's role in bank supervision is good for the U.S. economy? Here is what Alan Greenspan, chairman of the Federal Reserve, said on that topic in testimony before a House subcommittee in March:

> The supervisory activities of the Federal Reserve, for example, have benefited from its economic stabilization responsibilities and its recognition that safety and soundness goals for banks must be evaluated jointly with its responsibilities for the stability and growth of the economy. The Board believes that these joint responsibilities make for better supervisory and monetary policies than would result from either a supervisor divorced from economic responsibilities or a macroeconomic policymaker with no practical experience in the review of individual bank operations.

In addition, the central bank--with its mandate for price stability and full employment--can strike a balance between allowing no risk in the banking system and allowing too much risk. In comparison, a supervisory authority that doesn't have responsibility for monetary policy might just be too cautious about risk and unconsciously put the lid on economic growth by not allowing financial intermediaries to do what they do best--take calculated risks on businesses.

So, overall, we in the United States find that this structure that combines the Fed's role in monetary policy with its role as the lender of last resort (to help foster safety and soundness in the financial system) and its significant role in bank supervision fits our needs. We believe that generally it could fit the needs of other countries, although not in every case.

Now I will be the first to admit to supervision mistakes in the United States. One recipe for problems is to combine weak supervision and regulation with an unwillingness to let depositors take large losses. The United States certainly experienced this situation with our savings and loan debacle. In Latin America, results from mistakes have been of even greater proportions. The combination of misguided macroeconomic policies--and the inflation that inevitably accompanied such policies--together with a tradition of weak supervision, with very little attention to operations outside national borders, has resulted in hyperinflation, massive devaluations, and a virtual breakdown of the financial systems. These aren't isolated instances: Colombia and Chile in the early 1980s, Venezuela in the early and mid-1990s, and Mexico in 1995.

Chile and Colombia learned important lessons during a decade-long effort to correct the problems of systemic collapse. The supervisory systems in these countries have continued to evolve and seem to be progressing toward the international standards upheld by most industrialized economies. Chile has instituted a variety of other reforms, including a private pension system that, along with a low-inflation environment, has dealt in an effective way with a shortage of savings. As a reflection of the credibility achieved by these and other such reforms, Chile is the first Latin American country with which the Fed's Board of Governors has signed a statement of cooperation.

On the other side of the ledger are Mexico, whose recent problems are all too familiar, and Venezuela, a country whose banking misfortunes are particularly vivid in my memory because its banking crisis started with Banco Latino, a Venezuelan bank that had an Edge Act corporation in Miami. This organization became insolvent and sought protection of the U.S. bankruptcy courts--a first in banking history to my knowledge. From January 1994, when Banco Latino shut its doors in Miami, until August 1995, 17 more banks in that country were intervened. At present, the currency is approximately 480 bolivars to the dollar versus approximately 80 to the dollar

in 1993.

Looking back on these experiences leads me to believe that it's time to build on efforts to establish credibility in macroeconomic policies by focusing more attention on the issue of strong and independent supervision. Doing so is the best way for developing countries to instill trust in their banking system, encourage domestic savings and investment, and foster sustainable growth that is fast enough to raise living standards. And, based on our experience with financial system safety and soundness generally, and with bank supervision in particular, we in the Federal Reserve believe that it's important for the central bank to have some role in bank supervision. Our knowledge of the banking system helps in three ways: it enhances the implementation of monetary policy, it serves us well when we must act as the lender of last resort, and it results in appropriate balance in our regulatory stance.

Conclusion

In conclusion, I believe that as Latin American countries move farther along in the direction of market economies, they will experiment with variations of bank supervision and monetary policy. They may find that for all the same reasons that we believe it's important for a central bank to be independent--particularly when it comes to keeping inflation low--it's equally important for a supervisory authority to be independent. Since economic growth can't be fostered without confidence that the value of savings held in domestic currency will be maintained and that the banking system can be trusted as a repository for those savings, I believe that they may also find that strong and independent banking supervision is indispensable. And as time goes on they may also find, as we have, that supervision should be part of an independent central bank's duties.

Thanks for your interest and thanks to BAFT for inviting me to address this conference.

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