

LESSONS FROM RECENT GLOBAL FINANCIAL CRISES
FEDERAL RESERVE BANK OF CHICAGO

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I. I'd like to welcome all our distinguished guests here today to the Federal Reserve Bank of Chicago. We are very pleased to cosponsor this conference with the Bank for International Settlements.

II. I'd like to begin my remarks today by recounting an old fable about wisdom.

- A. As the story goes, an emperor ordered his wise men to summarize the essence of wisdom in a single book. After years of debate, the wise men produced a weighty tome. But during this time the emperor had grown old, and he realized to his dismay that he would have no time to digest the leviathan his wise men had produced.
- B. He then decided that a more concise text would be required. By the time the concise text was completed, the emperor, had grown so old and frail that he knew that he would have no time to understand even the shortened text. He therefore commanded his wisest man to summarize the content of the book in a single sentence.
- C. The wise man went away and thought and after pondering for a long time, he found the sentence. He ran to the emperor, who lay dying in his royal bedchamber. "Speak, O wisest of all my wise men", said the emperor. "What is the essence of wisdom that you have labored so long to distill?" "Your Highness," said the wise man, "the essence of wisdom, the essence of all knowledge, is this: "The world is complicated."

III. I have no doubt that, after this conference, we will be tempted to draw a similar conclusion regarding the essence of the lessons to be taken from recent global financial crises.

- A. But I am also confident that we will conclude the conference with a much better understanding of both the common traits and the differences which characterized the recent financial crises. This understanding is crucial if policymakers and economic agents are to undertake the efforts necessary to minimize the reoccurrence of such crises.
- B. This meeting is the third in a series of annual conferences devoted to international policy issues.
 - 1. The first conference was devoted to banking crises and cosponsored with the World Bank;
 - 2. the second was devoted to the Asian financial crisis and cosponsored with the International Monetary Fund.
 - 3. It's fitting that this third conference — which focuses on the lessons we can draw from these experiences — is cosponsored with the Bank of International Settlements (BIS).

IV. The BIS has been long dedicated to fostering international financial stability through cooperation among the world's central banks.

- A. The growing interdependence of our global economy has resulted in many benefits, but it also allows financial turmoil to spread across borders more rapidly than ever before. As a result, enhanced cooperation is required across nations to counter this shared threat.
- B. The increased frequency and severity of these global crises has increased the importance of the role played by the BIS as a focal point for international cooperation and collaboration among central banks and regulators.

V. By collaborating with leading international policy organizations, the Chicago Fed has been able to maintain the highest level of intellectual diversity at these conferences.

- A. This year, as in the past, we are pleased to have representatives from the academic, policymaker, and financial markets communities in attendance— representing more than 21 different countries.

VI. If one reflects on the wisdom gained from our past two conferences we come upon a seeming paradox. There is much that we do not know concerning financial crises, but there is also much that we do know.

- A. First, we have learned that no one country is immune to financial crisis. For example, over 130 countries including the United States have had at least one banking crisis within the past 20 years. In addition, during the more recent crises, countries thought to have had strong economic fundamentals were affected by the events which unfolded.

- B. Second, crises have as many elements that are common between them as they have differences that are unique to the particular country.
 - 1. Richard Portes best characterized this notion during our Asia conference last fall when he stated that, “all crises are the same, and all crises are different.”
 - 2. The countries suffering from financial crisis typically exhibit many of the same well known symptoms: poor or ineffective systems of banking supervision, lack of adequate accounting disclosure and transparency, and ineffective systems of corporate governance, among others.
 - 3. However, these countries also have unique elements that contributed to their crisis, including weak exchange rate regimes, significant debt and asset price deflation, systems of government directed credit, and unsustainable short- term capital flows, among others. It is typically these unique elements that carry economies over the edge.
- C. Third, infrastructure matters. Countries with strong economic fundamentals with well-developed financial infrastructure, legal frameworks, and private property rights are more immune to financial shocks and tend to enjoy more stable rates of economic growth.
 - 1. Such stability in the financial system breeds the necessary trust that Chairman Greenspan considers essential for a well functioning competitive economic system.
 - 2. In his words, “without mutual trust, and market participants abiding by a rule of law, no economy can prosper.”

VII. A country susceptible to financial crisis can be compared to a weakened immune system.

- A. An immune system with strong fundamentals can shrug off minor infections without harm, however, the same low-grade concerns can wreak havoc on a weakened immune system leading to systemic crisis. In this case, as with financial crises, an ounce of prevention is worth a pound of cure.
- B. Since we cannot fully protect against or eliminate every potential unique risk factor that might contribute to a crisis, giving proper attention to improving the world financial infrastructure is very appropriate — just as we seek to improve the human immune system as a primary defense against disease.

VIII. Although there seems to be a consensus regarding the value of a strong financial infrastructure in mitigating crises, there is less of a consensus regarding the optimal design of this infrastructure including the exact roles to played by the multilateral agencies in the grand design.

- A. Continuing with the medical example, What is the role of the doctor? What medicines should be prescribed to the patient? What is the correct dosage? How long should the patient continue on the medication? How will the patient be monitored? And when are they cured?
- B. For some illnesses, the answers to these questions are well known. For other more exotic diseases, more research is required.

- C. Similarly, in the case of financial crises, more research is needed on issues related to the optimal design of the financial infrastructure or architecture. I anticipate that much of the ongoing research into these issues will be discussed or referenced over the next couple of days and I look forward to hearing about it.

IX. Let me close my remarks with a note of caution regarding the possible redesign or fine-tuning of the international financial regulatory system.

- A. The growing complexity of financial institutions and markets— highlighted by their increased interconnectedness— has been taken by many analysts as grounds for supporting the case for more standardization of financial regulation and across international borders.
 - 1. Clearly such extrapolation is valid only if the coordinated regulatory policies chosen are socially optimal.
 - 2. This growing desire for coordinated regulation must be tempered with caution, given the inherent complexities associated with implementation.
- B. As is well known, inappropriate implementation of regulation could create more problems than it purports to solve.
 - 1. This occurs because regulation does not occur in a vacuum since firms and agents react to changes in regulation that affect its impact. In essence, regulators must know exactly how agents will react in order to implement optimal rules.
 - 2. However, given that regulators are generally looking from the outside in, such understanding is difficult. This is why enhancing market discipline is so important to the overall process of international regulation. Market discipline complements regulators' efforts allowing for more effective supervision and regulation.
 - 3. Enhancing market discipline through incentive compatible approaches will be the next challenge for international regulators in the years to come.
- C. During the next two days, we have an opportunity to hear a very distinguished group of experts who I know will add to our understanding of this complex topic. I look forward to an interesting and thought-provoking conference.