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Lessons from Recent Global Financial Crises

My remarks today will focus on recent global financial crises. In particular, I want to share with you some of the key lessons that policymakers have learned from these crises. My remarks will draw on the discussions from a series of international financial policy meetings held annually at the Federal Reserve Bank of Chicago. These conferences have been co-sponsored with the World Bank, the International Monetary Fund, the Bank for International Settlements, and the Journal of Banking and Finance. The first conference, held in 1997, was focused on global banking crises, the second on the Asian financial crisis, the third examined the lessons learned from these crises, and last year's meeting examined the measurement, management and macroeconomic implications of risk management in the global economy.

When Thailand was forced to devalue its currency in July of 1997, few economists could have foreseen the turmoil that would follow. Over the succeeding two years, financial crises swept through the developing world. Although Indonesia, South Korea, Malaysia, the Philippines, Hong Kong, Russia, and Brazil were among the hardest hit, few, if any developing economies escaped unaffected.

In the crisis countries, currencies and equity prices plummeted, economic growth turned into recession, wealth evaporated, jobs were destroyed, and poverty and school drop out rates soared. Private capital flows to emerging economies nose-dived, while industrial countries saw their export markets shrink. In the fall of 1998, after Russia's debt default and devaluation and the near collapse of the hedge fund Long Term Capital Management, international financial markets seized-up for nearly all high-risk borrowers including those in the United States and other developed economies. At that time, the Federal Reserve's Federal Open Market Committee lowered its intended or target federal funds rate three times, by a cumulative total of 75 basis points, in response to the systemic threat posed by these developments. Although systemic crisis was avoided, global growth did slow dramatically. Immediately following these events, doubts arose in some quarters about the market system as a reliable source or engine of prosperity and confidence in the official institutions that manage financial crises was shaken.

Despite this turmoil, we must remember that financial crises are nothing new. In the past 20 years alone, more than 125 countries, including the United States, have experienced at least one serious financial or banking crisis. In more than half of these episodes, a developing country's entire banking system became insolvent. In more than 40 cases the cost of resolving the crises averaged about 13 percent of GDP. In some developing countries estimates ranged from as much as 30 percent to 50 percent of GDP.

The initial lessons to be taken from recent experiences are, first, that no one country should consider itself immune to financial crisis and second, the cost of resolving a crisis once it has occurred is almost certain to be very high. The details of the more recent crises are probably familiar to everyone here today, so I will not describe them in detail. Just let me say that the countries suffering financial crises typically exhibited many of the same characteristics: government directed and connected lending; poor supervision of the financial system; an inadequate legal infrastructure; absence of a credit culture in which lenders and investors make judgements based on independent credit assessments and sound financial analysis; underdeveloped bond and long-term capital markets; lack of adequate accounting disclosure and transparency; ineffective systems of corporate governance; and excessive and imprudent risk-taking by financial institutions operating with explicit or implicit governmental guarantees, among others.

However, the crisis countries also had unique elements that contributed and in many cases, set off their particular episodes: weak fixed exchange rate regimes often pegged to the U.S. dollar, significant debt and asset price deflation, and persistent current account deficits, most often financed by short-term unstable foreign capital inflows. Thus, while most crises have much in common, they nevertheless can have unique precipitating elements.

The list of common characteristics observed in the crisis countries suggests lessons in and of themselves. Stated differently, the third and perhaps most important lesson is that infrastructure, broadly defined to include most of these common characteristics, matters. Countries with strong financial infrastructures including good operational, and not just theoretical systems of supervision and regulation, legal frameworks, and private property rights have tended to be more immune to financial shocks and have tended to enjoy more stable rates of growth. Such stability in the financial system breeds the necessary trust that the Federal Reserve considers essential to a well functioning competitive financial system. Research presented at our 1999 conference showed that weak legal institutions for corporate governance had an important effect on the extent of currency depreciations and stock market declines in the Asia crisis countries. Measures of legal protections, enforceability of contracts, corruption, and judiciary efficiency were all shown to be important in determining the depth of the crisis.

The fourth lesson was highlighted by former World Bank Chief Economist Joseph Stiglitz. Namely, a crisis is not over once financial markets stabilize. That is, we should never confuse financial variables with real economic variables or with the human dimension of a crisis. Exchange rates and interest rates are not ends in and of themselves but means to an end, which is to enhance the well being of the people of that country. We should be careful never to confuse ends with means, nor judge our success by anything other than an improvement in the ends themselves. This certainly does not mean that finance and the microstructure of financial markets are not important. I believe that modern finance as a discipline can be very useful in the design of economic institutions and policies—just like modern macroeconomics has and continues to be. The Asian crisis is a good example of this given that many of the countries had good macroeconomic fundamentals but significant imbalances in financial markets that escaped the scrutiny of economists and policy makers.

Although there seems to be a consensus regarding the value of a strong financial infrastructure, there is less of a consensus regarding the optimal design of this infrastructure. In particular, in the international context—what is the exact role to be played by the multilateral agencies and how do policies, institutions, instruments, and markets interact to precipitate crises? With regards to the latter question, another lesson we have learned is that direct measures of risk-taking can provide misleading assessments of overall exposure in an environment characterized by complex interconnections among policies, institutions, instruments, and markets. These interactions almost always produce unexpected, and in the statistical sense, non-normally distributed outcomes. For example, direct lending exposure of global depository financial institutions to Thailand, Malaysia, and South Korea were limited at the time of the crisis. However, attempts to diversify these risks in other more liquid and deep markets—including those in Hong Kong, Australia, Brazil, and Mexico—proved costly when these markets were adversely impacted by the evolving events and their spillover effects.

This growing complexity of institutions and markets—highlighted by increased interconnectedness driven by advances in technology, both information processing technology and financial technology or financial engineering—has been taken by some as grounds for supporting the case for a single global financial regulator. This growing desire for centralized regulation must be tempered with caution, given the inherent difficulties associated with the design and implementation of socially optimal regulation. As is well known, inappropriate implementation of even well designed regulation creates more problems than it solves. This is because regulation does not occur in a vacuum; firms and agents react to changes in regulation in ways to influence the effectiveness of the regulation. In essence, regulators must know exactly how economic agents will react in order to implement optimal regulatory rules. However, given that regulators are generally looking from the outside in, such understanding is difficult and elusive. This is why enhancing market discipline is so important to the overall process of international harmonization of regulation.

Market discipline complements regulators' efforts allowing for more effective supervision. As I noted earlier, there is no way regulators can ensure a fail safe financial system. This is another key lesson from recent financial crises. We need help and market discipline provides a partial solution. Enhancing market discipline through dynamic incentive compatible approaches is the next challenge confronting the Federal Reserve and regulators in general. From the perspective of the Federal Reserve, we must respond to the recently passed financial modernization legislation, the Gramm-Leach-Bliley Act, which allows full affiliation of banking, securities and insurance activities creating large complex banking organizations which have to be effectively supervised and regulated. Clearly, that regulation must be adaptive. Similarly, in the case of emerging markets and transitioning economies, regulation must be dynamic and adaptive because these markets are emerging and in transition.

We at the Chicago Fed have long encouraged more market discipline through increased disclosure and transparency and through approaches such as mandatory issuance of subordinated debt by large complex banking organizations. In our view, mandatory subordinated debt is incentive compatible in that it aligns the incentives and risk preferences of bondholders with those of bank supervisors. Being subordinated to other liabilities, the debt holders would be risk sensitive and would monitor and discipline bank behavior. They would demand higher rates from riskier banks—a direct effect—and have stronger incentives to quickly resolve problems and avoid forbearance and its associated costs. In addition, increases in interest rate spreads provide signals to supervisors that risk is increasing—an indirect effect. A recent issue of the Chicago Fed's journal, Economic Perspectives, contains a comprehensive article on subordinated debt and its advantages as a tool for regulators in supervising large complex banking organizations. The article can be downloaded from the Chicago Fed's web site, www.chicagofed.org. I should note that the U.S. Shadow Financial Regulatory Committee has endorsed the subordinated debt concept. And the shadow financial regulatory committees in Europe and Japan have also endorsed it.

Obviously, I could spend the next hour describing other lessons that policymakers have learned from recent financial crises. Given that my time is limited, let me close with a few observations regarding financial derivatives and the conduct of economic policy.

Regarding financial derivatives and their role in contributing to financial crises and systemic risk, it turns out that all the talk about financial threats posed by derivatives was probably overblown. That is, recent crises remind us that by and large, the mistakes of the past few years were rather ordinary and not so exotic—making bad loans, typically in real estate, failure to evaluate counterparty risk, or relying on the lofty reputations of firm principals (recall Long Term Capital Management). These are age-old problems, especially in the banking industry. The lesson here is that derivatives were not the major villain in recent crises. This suggests that maybe the most important lesson to be taken from recent global crises is not to forget the old lessons!

With regards to matters of economic policy, there is a fairly well established consensus that a county can choose to operate with any two of the following three regimes: fixed exchange rates, free capital flows, or an independent monetary policy. Given this constraint, the lesson here seems fairly clear. Countries must carefully evaluate the advantages and disadvantages of fixed exchange rates, free capital flows, and an independent monetary policy relative to their own initial conditions and national preferences before making their choices.

Let me close by saying that I hope that I have given you a better sense of what policy makers have learned from recent financial crises. Although much what I have said seems simple and obvious, it must be remembered that most of these lessons have proved elusive even to the most sophisticated of policymakers.