THE ROY BRIDGE MEMORIAL LECTURE

BY

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International Economic Cooperation

I am greatly honored to be here this evening to present the annual Roy Bridge Memorial Lecture. I am well aware of being the first American public official to deliver this lecture and feel it is particularly apt that you have given that honor to an official of the Federal Reserve Bank of New York. Roy Bridge's American counterpart was Charles Coombs of the New York Fed, the man who taught me a great deal about the workings of the international economy and especially the foreign exchange markets when he served as an adviser to the commercial bank at which I worked.

Both Roy Bridge and Charlie Coombs were legendary experts on foreign exchange matters and were closely involved in international financial policy in the 1960s and '70s. They believed that it was international financial cooperation that underpinned the functioning of the Bretton Woods System, which they fought so valiantly to preserve. The friendship between Messrs. Bridge and Coombs reminded many of the extraordinary friendship and cooperation between Montagu Norman and Benjamin Strong, the first head of the New York Fed, and Norman's co-creator of central banking cooperation. That is a legacy which my good friend Eddie George and I try to keep alive today.

This evening I would like to share some thoughts on international financial cooperation -- a subject that obviously would have met with Roy Bridge's approval. Like Roy Bridge, I fully subscribe to the view that proper functioning of the
international financial system requires close and on-going cooperation among central bankers and market participants. I hope that my remarks will honor, however inadequately, Roy Bridge's remarkable career at the Bank of England and his contributions to the cause of international cooperation.

Discussions of international economic cooperation are usually concerned with efforts of major countries to coordinate their foreign exchange market intervention, or their monetary or fiscal policies. But economic cooperation is much broader in scope than just the coordination of macroeconomic policy actions by central banks and national governments. I believe the focus on macroeconomic issues alone leads to a considerable under-appreciation of international cooperative efforts.

International economic cooperation, in the broader context, involves both the public and private sectors and spans a wide range of activities beyond the macroeconomic and financial arena. These include agreements on trade policy, shipping and navigation, public health standards and product safety. In fact, international agreements in the nonfinancial area deserve much of the credit for the smooth flow of commerce that we now take for granted.

Though I have that broad context in mind, it is not my intention to offer a comprehensive picture of international cooperation. Instead, I will highlight some financial issues that have been at the forefront of central bank cooperation in recent years. Specifically, I would like to focus on three broad
areas: banking supervision and related issues concerning financial markets; payment and settlement issues; and financial policies aimed at dealing with international financial crises or major financial sector problems.

First, let me be clear that, in my view, international cooperation is not a coded phrase for central bankers and finance ministers telling market participants what to do. The evolution and expansion of financial markets over the last thirty years has moved too far for anyone to believe that central bankers alone have the wisdom or power to absolutely control markets or behavior. Nor do I think that the private sector is always right or that the greed of the most aggressive trader produces the best results for society. Rather, international cooperation is public servants and market participants working together to make markets function as best they can.

Indeed, financial markets are a highly cooperative form of competition, and depend upon shared assumptions and expectations of all participants about the rules of the game, and those rules being followed. Thus, international cooperation must begin with the market participants themselves and perhaps best at the level of each marketplace.

When I got into banking in 1967, foreign exchange markets were relatively simple and not highly profitable because of the rules of the Bretton Woods System. Perhaps because of that relative simplicity and absence of the boxcar-size profits known
today, informal cooperation among dealers, chief dealers and their bosses was quite common. If one of us saw something that looked strange at another institution, we would make a quiet phone call and suggest somebody look into it. We assumed, correctly, that the favor would be returned if the need arose. To the degree that is not happening in the much fiercer competitive environment in which you must live, I recommend it to you. It has merit if for no other reason than that a quiet phone call from a friendly competitor is likely to have a less unpleasant aftermath than one of those quiet phone calls from the Bank of England or the considerably less subtle boot in the backside from the New York Fed.

The same kind of courtesy can extend internationally. Note that I do not recommend this informal "community foreign exchange market protection association" as a substitute for the internal controls so necessary in each bank or for the appropriate supervision by regulators, but as an additional protection for all market participants from the rogue trader or the rogue group within a market participant. It is rare, indeed, that a number of people do not say after one of these unfortunate incidents that they saw something strange going on or were aware that such and such a dealer was swinging much too big and too wide.

More formal cooperation in the private sector is demonstrated by such efforts as the Group of Thirty study on derivatives and the many fine works produced by the Foreign
Exchange Committee in New York, a private sector group encouraged and supported by the New York Fed.

Now let me turn to the central banks and our role.

It is clear that international cooperation on financial issues of mutual concern to central banks has improved significantly in recent years. But, I believe that increasingly greater internationalization of the financial marketplace requires even stronger on-going cooperative efforts to reduce potential systemic risk, and to deal with other major challenges to the stability of the international financial system. Indeed, international cooperation on many financial matters is no longer just a good thing, but an absolute necessity, not only to deal with ad hoc financial problems or crises but also to ensure the day-to-day functioning of the international financial and payment systems. The on-going financial innovations and internationalization of financial activities have greatly increased the degree of interdependence among national financial policies and have exposed serious gaps in the supervisory apparatus. They also have put new pressures on payment and settlement systems. Any systemic risk stemming from a major disruption in one market is now essentially international in character and requires cooperative remedies.

Given the extensive public discussions of banking supervision and capital standards in recent years, you probably will not be surprised to hear me say that international
cooperation in bank oversight, at least among the G-10 countries, has advanced significantly over the last decade. Much of this progress has occurred in the context of the Basle Committee on Banking Supervision, which has acted as the key point of contact to safeguard the stability of the financial system and to ensure fair competition among banks across countries.

One of the most important, and perhaps the best known, achievements in international cooperation on banking supervision is the Capital Accord of 1988. The Accord established minimum capital standards and helped level the playing field for internationally active banks. While there were many forces at work, the Accord stressed the importance of capital as the bedrock of financial strength, and had the effect of generally raising bank capital positions and making the banking system safer.

Another major recent achievement in coordinating banking supervision was the 1992 revision of the Basle Concordat to incorporate "minimum standards" for the supervision of international banking groups and their cross-border establishments. You will recall that the original 1975 Concordat had delineated the roles of host and home country supervisors in the aftermath of the failure of Herstatt Bank, and its subsequent 1983 revision established the principle of consolidated supervision for all internationally active banks.
Over the last few years, the Basle Committee on Banking Supervision has been working to develop capital requirements for market risks in banks' trading activities to complement the original Capital Accord, which dealt exclusively with credit risk. The Committee's April 1993 draft proposals generated extensive comments from market participants, with many of them suggesting alternatives to the proposed approach based on banks' own internal models for measuring risk in their trading activities. In response, the Committee has been exploring the feasibility of an approach under which banks could be given the choice between using the standard approach as the basis for calculating the capital charge, or using their own model, which I strongly prefer. These proposals are being made public today and I look forward to the comments of banks and other interested parties to the changes the Basle Committee is putting forward.

The discussions on these issues reflect a basic tension that has emerged in the efforts to promulgate capital standards: the desire to have easily understood rules that are not mathematically complex competing with the desire for more precise, if complex, standards. It is likely that the credit and market risk parts of the extended Capital Accord will end up with different approaches.

Two other cooperative initiatives in the financial supervision area are worth mentioning. First, since January 1993, an informal tripartite working party of G-10 banking,
securities and insurance supervisors has been working toward achieving consistency in supervisory approaches to similar type risks in banking and the so-called financial conglomerates -- companies engaged in banking, insurance and securities, with exclusive or predominant activities in at least two of those financial sectors. The tripartite group is developing a deeper understanding of supervisory approaches in different sectors, and has made progress in identifying the main issues about which all supervisors are concerned. But further work is needed to achieve agreements on capital standards and other matters.

Second, supervisors of both banks and securities firms have made good progress in developing a cooperative approach to dealing with risks in derivatives. Last July, the Basle Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions (IOSCO), acted jointly, for the first time, in issuing risk management guidelines for derivatives. The two sets of guidelines are consistent and are based on three basic principles: appropriate oversight by boards of directors and senior management, adequate risk management, and comprehensive internal controls and audit procedures. I hope that such cooperation will strengthen and expand over time to a broader range of issues. For example, the Basle Committee and IOSCO have been working constructively on a framework for regulatory reporting and, I also expect the Basle
Committee's market risk proposal to further stimulate the Basle/IOSCO dialogue.

On other more general aspects of derivatives activities, G-10 central banks, the Group of Thirty and the Institute for International Finance, among others, have issued reports aimed at achieving greater public disclosure of risks in derivatives and enhanced market transparency. I regard these areas as critical for both risk management and banking supervision. A striking aspect of the markets in the last year has been the recurrent dramatic problem situations at individual institutions, accompanied by tremendous uncertainty as to the exact nature of market forces at work and the size of overhang positions. This uncertainty created considerable potential for volatile and disorderly markets.

In this environment, I see a strong and urgent need for bold and ambitious disclosure standards. While all of us recognize that greater disclosure and market transparency will not eliminate abuse or fraud, they will reduce the potential for such problems. Weak and inadequate information systems clearly add to the difficulties of senior management and supervisors in detecting fraud related to complex trading activities.

The observations and recommendations presented in the Fisher Report, a discussion paper released last September by the G-10 central banks, provide a good foundation for enhancing public disclosure of risks in trading of derivatives and other financial
instruments. With similar efforts underway in the private sector, I think it is reasonable to expect significant progress in this area over the near term. The 1994 annual reports of major U.S. banks -- many just out -- show that substantial strides are being made.

Personally, I am convinced that our collective efforts over the past years have prevented some incipient financial problems from developing and have ameliorated others. But I am also concerned that as we have intensified our efforts on the official side, perhaps particularly in banking regulation and supervision, market participants run the risk of making the mistake of accepting official minimum standards in place of their own best judgments. As financial markets have grown more complex, regulators and supervisors are drawn into greater levels of detail, and necessarily so. But the increasingly-detailed minimum standards we suggest, whether for capital, trading practices, audit controls or disclosure, should not -- and really cannot -- be a substitute for the optimum levels of capital, the optimum trading practices, and the optimum financial disclosures that market participants should expect of themselves.

In recent years, the rapid growth of cross-border financial activity and the worldwide inter-relationship of payment and settlement systems have heightened the importance of payment issues for the safety and soundness of the international
financial system. In inter-connected markets, payment problems in any market spread quickly around the world.

The G-10 central banks, largely working through the Basle Committee on Payment and Settlement Systems, which I chair, have focused on cooperative efforts to define and set out the benefits and limits of netting and to promote safer payments arrangements. In my view, the Lamfalussy report, released in November 1990, was a particularly important step in central bank cooperation on coping with the payment system risks. The report developed minimum standards for the operation of netting schemes, together with a cooperative oversight arrangement for central banks as they deal with netting arrangements.

Central banks and the private sector have devoted much recent effort to defining and understanding Herstatt risk -- the risk of settlement failure in foreign exchange caused by temporal gaps -- and finding ways of mitigating its severity, if not eliminating it. Herstatt risk, named after the German bank which failed in 1974, is especially troublesome because it necessarily goes beyond national borders and affects the financial system globally.

While many important changes put in place since Herstatt have helped reduce the settlement risk in foreign exchange transactions, we are still far from eliminating Herstatt risk. I am encouraged, however, that efforts to deal with Herstatt risk have moved ahead at a faster pace over the last two years or so.
In particular, the Noel report, released in September 1993 by the Committee on Payment and Settlement Systems, the work of the New York Foreign Exchange Committee, summarized in a study issued last October, and a recent report by the New York Clearing House Association, have made very significant contributions to understanding the issues involved in reducing or eliminating Herstatt risk.

A steering committee of central bank payments experts, working under the auspices of the Committee on Payment and Settlement Systems, is taking a coordinated look at the dimensions and sources of Herstatt risk, including a series of interviews with financial market participants in many countries. That work is not yet complete, but it should help identify potential vulnerabilities in current arrangements and suggest methods of dealing with them. It is my hope that the recent substantial private and public sector efforts dedicated to this issue would lead to the elimination, or at least the near-elimination, of Herstatt risk. After more than 20 years, that goal is long overdue.

The reason to recount the number of recent reports is to show the depth of the dialogue on the goals and means of dealing with Herstatt risk. While we have not yet solved Herstatt risk, the tacit agreement of the public and private sectors to debate the issues at a high level with all interested parties and publicly airing potential solutions, augurs well for the process.
This encourages maximum participation and fullest disclosure of new ideas and the delineation of risks. It might not be the most efficient way, but I believe it is the best way of turning the dialogue into a lasting solution.

Most everyone would agree that the most important objective of international cooperation in the context of financial problems or crises is to avoid or contain systemic risk. Since central banks are the ultimate sources of liquidity, their involvement in the cooperative process is critical to solving financial problems and containing systemic threats. In finding solutions to financial problems, however, central banks are not, and should not be, interested in providing protection against "normal" risks in the financial system. After all, risk taking is an inherent part of banking and finance in market economies.

I also want to stress another general point: international financial crises or problems and their solutions usually involve important macroeconomic policy dimensions. This certainly has been true for most of the major international financial problems of the 1980s and the 1990s -- the LDC debt crisis of the early 1980s, the dollar misalignment that prompted the September 1985 Plaza agreement, the October 1987 stock market crash, the fall 1992 exchange rate crisis of the European Monetary System, and the recent financial difficulties of Mexico.

The importance of macroeconomic forces in causing and resolving financial crises has increased significantly in recent
years. The main reason is that greatly enhanced international integration and increased competition have tightened linkages between macroeconomic factors and financial markets. Actual or expected changes in monetary policy, for example, can cause sudden shifts in market confidence and huge changes in financial flows across borders, leading to dislocations in the countries involved, and increasing potential risks to the entire financial system and the world economy. Effective solutions to financial crises, therefore, require that we also address their macroeconomic causes and consequences.

Central banks' role in resolving international financial problems is crucial because they exercise joint responsibilities for both macroeconomic stability and oversight of the financial system, while, at the same time, they are the ultimate sources of liquidity. Thus, central banks are in a unique position to balance conflicting short-run interests stemming from the resolution of a crisis and the broader long-run consequences of that resolution. The position of the Federal Reserve in cooperative efforts is all the more important because of the role of the dollar in international finance.

Central bank cooperation has played a critical role in containing systemic consequences of major international financial crises over the years. For example, when the LDC debt crisis broke publicly in 1982, with a potential default by Mexico on more than $50 billion debt to international commercial banks,
central banks acted quickly to organize the provision of immediate liquidity support, while a broader, permanent solution was worked out. The effort was led by the Federal Reserve, but it would not have succeeded without the active cooperation of the Bank of England and other central banks. As Paul Volcker wrote some years later, central bankers, under the leadership of Lord Richardson and Fritz Leutwiler, then president of the BIS, "instinctively understood what was at stake".

The inter-governmental and commercial bank cooperation to deal with broader aspects of the LDC debt problem was much harder to achieve and less effective. As you know, it took more than a decade and many debt rescheduling exercises and debt service reduction operations to resolve the problems that followed the debt crisis of the early 1980s. Even here, however, central bankers persevered with the necessary patience to encourage continued engagement among negotiators and helped balance long-term considerations of financial prudence and macroeconomic goals.

Cooperation among central banks also worked effectively to contain the consequences of the October 1987 abrupt drop in stock prices in the U.S. and other countries. Central banks acted promptly to make liquidity available to financial markets, without losing sight of prudential concerns. During the crisis period, the Federal Reserve and other major central banks were engaged in nearly continuous consultations with one another,
drawing upon knowledge obtained from contacts with commercial banks and securities houses.

But October 1987 also spotlighted an element that has greatly complicated international coordination in market crises since then -- and that is the large flow of highly mobile international capital. The factors that motivate international investors are often different from those of domestic financial market participants, which changes the relationship between financial and macroeconomic variables. Large and persistent inflows of international capital may make domestic financial conditions appear more benign than warranted and may even lull policymakers into believing there is more time than they really have for macroeconomic adjustment. But as we have seen more than once, the speed at which international investors redirect their capital has greatly shortened the timeframe in which global solutions have to be identified and agreed upon.

The breakdown of the Exchange Rate Mechanism of the European Monetary System in 1992 represented a particularly striking example of a crisis that reflected a collision between macroeconomic forces and the new highly integrated international financial environment. Given the requirement of a high degree of macroeconomic convergence, financial markets could not endure for long the inconsistency between the interlocked pegged exchange rates and the wide disparities in performance across European economies. In reviewing this episode, I cannot help but notice
that the inflow of international capital contributed importantly to the ability of EC members to sustain divergent policies, thereby adding to the severity of the adjustment when it came.

The incongruence between macroeconomic forces and the new international financial environment also is fundamental to understanding the broader context of the recent Mexican financial problems. In 1992 and 1993, reflecting declining inflation and on-going fundamental improvements in its economic and financial structure, Mexico attracted huge amounts of portfolio capital inflows and foreign direct investment. But, at the same time, Mexico was losing external competitiveness and its current account deficit widened significantly. In 1994, foreign investors became increasingly less confident about the Mexican economy as uncertainties caused by some noneconomic events -- the Chiapas uprising, political assassinations and the August election -- unfolded. And, the Mexican authorities supported the peso exchange rate and financed the large and increasing current account deficit by short-term borrowing and drawing down their reserves.

One interpretation of the Mexican crisis comes from looking closely at the international reserve position of the Banco de Mexico during 1994. After each of the political shocks, the market stabilized and international reserves held their new lower levels and then began to increase slowly. The authorities, understandably in my view, thought that they should interpret
these results as renewed external confidence in the country and its policies. Another interpretation, with the gift of hindsight, is that we were looking at the last gasp of a long bull market in Mexican financial assets. As is almost always the case with a long-in-the-tooth bull market, it turned with a vengeance. Money not only stopped flowing into Mexico, but moved out rapidly and made it impossible to hold the exchange rate. The result was a disorderly retreat and the severe readjustment we have been seeing over the last few months.

From my perspective, the large financial support package for Mexico arranged by the international community, under the leadership of the U.S. reflected the seriousness of the situation. While it is important to the U.S. that Mexico succeed in regaining financial market confidence and reestablishing noninflationary growth and financial stability, the stakes for the entire international community also are high. The Mexican situation has had the potential for considerable systemic harm to the global financial system and the world economy.

The implications of the Mexican situation also need to be considered in the wider context of the post-Cold War period in which almost all nations have been trying to emulate free market-oriented approaches of the industrialized democracies. Mexico has been widely perceived as a model of economic transition from a rigid state-directed economic system toward a free-market system. A reversal of Mexico's reforms and a spread of its
financial problems to other emerging economies could halt, or even reverse, the international trend toward free market-oriented approaches.

The international context of recent financial difficulties highlights the critical importance of maintaining sound domestic economic and financial policies in today's global financial environment. By inducing capital inflows from abroad and providing access to international markets, sound domestic policies deliver significant additional benefits to an economy through international channels. But domestic policy mistakes elicit quick and harsh punishment on an economy from international sources, and also may reverberate around the globe at a prodigious pace, requiring international solutions.

The increasingly global financial environment also raises some broader fundamental issues about the process of financial disruptions and crises in our free market-based financial system: what are the critical forces in the development of international financial problems? how can such problems be prevented? and what types of mechanisms are needed to deal with them once they do occur? We in central banks have been thinking about these issues for some time and recent events have provided an impetus to accelerate that process. In this respect, I might mention that G-7 finance ministers and central bank governors have agreed to make progress on issues concerning more effective prevention and
coordination mechanisms dealing with international financial problems by the time of the G-7 Halifax meeting in June.

One general issue raised by the Mexican problem and fears of other problems in the future is whether we need a more formal international institutional structure. My own view is that we definitely do not need to create another institution or a new bureaucracy. But a positive and necessary step to take would be to better delineate responsibilities for more intensive monitoring and warning systems within existing structures. We need to understand the process of financial crises in the new international environment with much greater clarity before we seriously consider making any substantive changes in institutional arrangements.

Another general issue that I would like to raise is whether, in today's free market-oriented global financial system, we need to find a mechanism that incorporates for sovereign nations the principles and procedures of private sector debt workout, features such as prioritization of claims and standstill provisions. Developing such a mechanism is important if we wish to facilitate early resolution of these problems -- always key in workout situations -- and give the private sector a larger role. I am optimistic and hopeful that our need for such mechanisms will be rare, and that an episode such as the Mexican situation will lead to a self-correcting mechanism by sensitizing other
countries to avoid overdependence on large inflows of portfolio capital.

In closing, I want to emphasize that international cooperation ultimately depends on mutual confidence and trust, and good working relationships among people involved in decision-making. These intangibles are particularly important in times of stress when decisions must be made quickly with little time for the deliberative process. Central bankers have a long tradition of close contacts and working well with each other. The BIS monthly meetings in Basle, for example, provide an opportunity for central bankers not only to exchange views on current developments and policies but also to get to know each other on a personal level. Over the years, mutual understanding based on these contacts has proven vital in dealing with problem situations.

And yet all the contacts among central bankers will accomplish little if you, the people who are in the markets every day trying to do the best you can for your customers and maximizing profits for your institutions, do not keep ever present your own collective interest in and responsibility for the safety and soundness of financial markets. As somebody who was a commercial banker for twenty-two years, with responsibility for foreign exchange operations for that entire period, and a central banker for just over three years, I could not be more convinced that you and we are in this together. The world in
which we live is not only a saner one, but over time a much more consistently profitable one for you, if central bankers and market practitioners work together to make these complicated, difficult and yet intellectually fascinating markets both safe and sound.

Thank you for giving me the honor to present this year's Roy Bridge Memorial Lecture.

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