For release on delivery
10 30 a m EDT
September 24, 1991

Remarks by

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before the

16th Annual Conference of the

International Organization of Securities Commissions

Washington, D C

September 24, 1991

I am pleased to have this opportunity to address the membership of IOSCO These are certainly challenging and exciting times for financial markets around the globe In many parts of the world, control of production and resources has begun to move quickly from centralized hands, those of the state, to the hands of private owners Securities markets, either directly or indirectly, will be playing a key role in this process and in drawing global capital resources to economies in the process of liberalization Meanwhile, the inevitable trend toward automation of securities markets promises new efficiencies and closer integration of all financial markets around the world but carries along with it new risks as well

In my remarks today, I would like to address these challenges by considering some basic, but often overlooked, ingredients of a successful market economy In particular, I would like to focus on the fundamental role of contract law and the importance of supervision to the integrity of markets and success of market systems Then, I would like to draw some implications for global securities market developments.

The jury has reached its decision on the merits of market versus centrally directed economic systems and the verdict has been decisively rendered in favor of well-structured market systems Nations with well-functioning market systems have provided consistently higher living standards for their citizens by more effectively unleashing the creativity of their people to respond to economic needs These systems also have proven to be remarkably adaptable to economic shocks

An excellent example of the importance of market systems is the contrast between Western and Eastern Europe in the postwar period In effect, we have had a controlled experiment pitting centrally

directed economies against market systems, the likes of which has been rare in economics and finance The outcome has been striking The standard of living of Western European nations has been roughly on the order of ten times higher than in Eastern Europe However, this is only part of the story Western European nations have provided their citizens with much greater choice through a vastly richer variety of goods and services, not to mention their considerably higher quality At the same time, the market systems of Western Europe have proven to be highly complementary with personal freedom and democratic political systems

Key to the success of market economies in Western Europe, and elsewhere, have been financial systems that rely on market signals to guide the public's savings to productive uses These market systems also have provided a wider array of financial assets to investors that can meet their requirements for future income and tolerances for risk Moreover, noteworthy in recent years has been a growing availability of financial instruments that enable price risks to be shifted to parties most willing and able to absorb these risks Investors have increasingly been able to select the trade-off between return and risk that best suits their particular needs

In contrast, the state-dominated economies of Eastern Europe and the Soviet Union, as well as those elsewhere in the world, have provided their public with very little choice and unattractive returns, indeed, typically the only asset available was a bank deposit with a nominal return below the effective inflation rate Moreover, the amount of financial assets that people accumulated--their saving--was not really subject to their control and thus was not a reflection of deliberate decisions to protect themselves against unexpected needs

or expected future outlays, rather, financial saving reflected price controls and lack of supply of goods and services

Enterprises, similarly, were greatly limited in their access to credit Credit supplies fell well short of demands as price allocation--in this case, through interest rates and underwriting standards--was shunned as a means of screening borrowers Thus, those borrowers with projects promising high returns stood no better chance of securing credit resources than those with wasteful alternatives, especially those having sponsors with political clout As a consequence, many of the investment projects that could have contributed the most to public welfare and economic growth did not get financed Credit instead was diverted to projects with poor prospective returns or, worse yet, to cover operating losses Not only was access to credit highly circumscribed but the ability to tailor credit arrangements to meet the particular circumstances of the borrower was unavailable

Efforts now under way to introduce market system reforms in Eastern Europe and the Soviet Union and elsewhere around the world must focus on building a strong legal infrastructure Indeed, the cornerstone of any well-functioning market system is the law of contracts Contract law in well-functioning market systems recognizes that people are going to be reluctant to exchange items of value unless they are clear about what they are going to receive in return Such contract law recognizes that parties to exchange will need to have reasonable assurances of such returns and a readily available method of recourse to enforcement of the contract in the event that their counterparty does not comply

A system of strong contract law thus fosters integrity and confidence in a market system And where there is integrity and

confidence, people become more willing to make commitments, especially longer-term ones, and do not require large premiums as compensation for uncertainties about contract performance. Such confidence, along with widespread dissemination of price and trade information, plays a key role in guiding scarce resources to their most valued uses and in facilitating innovation

Complementing the law of contracts as part of the legal infrastructure of a market economy is the supervisory system, which ensures that the law of contracts--rules of the game--are being enforced The government, of course, has an important part to play, including through the judicial system, in ensuring that the rules are being enforced The supervisory system bolsters private markets by reducing the scope for fraud and deception and provides readily available avenues for recourse in the event the counterparty to the contract fails to comply

The integrity of markets is especially important in the financial sector, where resources get channeled through the capital formation process to meeting future economic needs and enhancing the productivity of the labor force The nature of financial contracts is one in which valuable resources are surrendered today for a promise to pay a certain amount or a share of earnings in the future--in contrast to transactions in which goods of immediate value are exchanged For investors to be willing to surrender resources for a future promise, they must have confidence in the contract process They must be satisfied that they are not being deceived about the prospects for future earnings or subject to fraud and that they have readily available recourse through a fair system of adjudication in the event that the terms of the contract are not met When these conditions are not in place, investors will require large uncertainty premiums to

cover the risk of possible contract failure, creating distortions to the capital formation process Expressed differently, a solid legal infrastructure based on strong contract law acts to lower risks that are reducible and hence to lower the cost of capital, allowing capital resources to be drawn to their most highly valued and beneficial uses

Thus, supervision has an especially important part to play in financial markets through ensuring adequate disclosure of relevant information, the prevention of fraud, and measures to ensure contract performance Indeed, we have seen where self-regulation among private participants has developed in various financial markets once the participants have realized that public confidence in those markets necessitated stronger measures to ensure contract performance In today's complex markets, millions of dollars are typically put at risk between counterparties through oral agreements, often by phone, and only later confirmed by legal documents Whatever the ethical standards market participants may employ in their personal dealings, in the markets they must be perceived as beyond reproach, or the very basis of their dealings--and, indeed, the structure of the markets--will erode. This is why the most recent market scandals, both here and abroad, are so disturbing They undermine the integrity of the market process and hence the efficiency of the market system

Governments in market economies generally have come to play an important role in the supervision of financial markets as it has come to be realized that there is considerable scope through appropriate policies for reducing transactions costs and improving market liquidity, as well as protecting less sophisticated investors This comes about through standards for disclosure, financial standards for key market participants, and procedures that ensure enforcement of

financial market contracts In addition, the government often has a particular interest in the compliance of certain contracts such as in cases in which the taxpayers are at risk when a bank fails owing to large defaults on contracts by its borrowers In other words, banking supervisors enhance the contract process while, at the same time, protecting the safety net, and ultimately taxpayers, from abuses, the banking safety net, involving deposit insurance and access to liquidity from the central bank, can encourage banks to take on undesirable amounts of credit and liquidity risk which requires official supervision to protect taxpayers from losses

Supervision also is central to securities markets, which typically take on more importance as economic and financial systems mature Banks, through longer-term relationships with their borrowers, have ways of gaining access to relevant information bearing on the ability of borrowers to meet their obligations Banks also have considerable flexibility in customizing individual loans, through collateral arrangements and the like, to protect themselves in the event of default In contrast, securities markets, by their very nature, are impersonal, as lenders and borrowers frequently are far removed from each other Thus, access to relevant information bearing on the issuer's capacity to meet contractual obligations and protections for the investor can be problematic, creating an important role for the securities supervisor to strengthen the contract process. The supervisory system enhances the contract process by ensuring the adequacy and accuracy of information provided to investors and by developing convenient procedures for resolving disputes and enforcing compliance with contractual terms This supervisory role derives from the need to remove fraud from the contract process and, again, the recognition that market integrity is essential to a market system

Effective supervision in the securities area, as in the banking sphere, requires a certain degree of flexibility For example, some investors in securities--such as large professional investors--are better positioned to glean relevant information on the earnings capacity of the issuer than others Consequently, costs of offering securities to these investors can be lowered by requiring less formal disclosure on the presumption that such investors already have access to relevant information

The important role of the securities market supervisory system in strengthening the contract process carries over to the secondary market Indeed, because difficulties in the secondary market can quickly spill over to other markets, securities supervisors must seek to limit the prospects for contract failure Failure to deliver securities or cash in such transactions, which becomes more likely in the event of a large price movement in a volatile market, can impose losses on the counterparty--and potentially the counterparty's broker and clearing organization This can threaten the counterparty's performance on other contracts and can undermine confidence in securities markets and their clearing organizations more broadly In other words, the potential for such failure has broad systemic consequences--it imposes externalities on other markets and participants Consequently, securities supervisors, both self-regulators and public-sector supervisors, can reduce such systemic risks through setting financial standards for brokers and dealers and members of clearing organizations, imposing sufficient margin, and ensuring that adequate safeguards in the form of capital and liquidity are in place.

Solid supervisory systems become even more important as financial markets avail themselves of modern communications and

information processing technology In such modern securities markets, as I have noted, contracts in the first instance are entered into over the phone or through electronic impulses rather than through the signing of legal documents or even handshakes These technological developments, which are especially well-suited to securities markets, have lowered transactions costs appreciably and have expanded the availability of financial instruments to borrowers and lenders They also have provided the means for strengthening clearing and settlement systems and reducing systemic risk At the same time, improvements in telecommunications and information processing have contributed to the tightening of linkages among markets, both domestically and globally. However, these developments mean that disruptions in one market can more suddenly be transmitted to other markets They also open up new avenues for abuses and new vulnerabilities which, if not supervised, could undermine progress Investors need to be convinced that these systems are not vulnerable to breakdowns, unauthorized entry or tampering Because of spillover effects, supervisors have an important oversight role to perform in the automation of securities markets and their clearing and settlement systems

Financial markets that do not provide adequate supervision stand to lose business to other markets, especially as the globalization process continues and better alternatives to domestic markets develop Lax supervision may suffice in some kinds of markets, but stands little chance of succeeding in financial markets which rely so heavily on confidence and trust and the supporting legal infrastructure

While adequate supervision is necessary, there is a danger that supervision and regulation can be excessive We can find numerous examples--in Eastern Europe, the Soviet Union, and

elsewhere--of financial markets being repressed by excessive government involvement As I noted earlier, many of these systems have experienced severe misallocations of resources that have greatly retarded the development of their economies Even in more market-oriented systems, there can be excessive supervision leading to unnecessarily high transactions costs, distortions to asset prices, and a stifling of innovation In such circumstances, incentives mount for residents to shift their business to other markets

Today, it is comforting that numerous countries around the world with overregulated financial systems are seeking to liberalize their financial markets to complement moves to market economies and to attract much needed capital from abroad Nowhere are financial system reforms based on a strong legal infrastructure more important than in Eastern Europe and the Soviet Union. These economies have vast potential for improving the welfare of their citizens through development and growth, given their human and, in many cases, natural resources To do so will require substantial reforms to their domestic banking systems to provide an efficient payment system and to ensure sound credit judgment as well as an appropriately balanced bank supervisory system However, for these labor-intensive and fairly primitively organized systems to reach their potential will require the application of substantial amounts of foreign capital and Western know-how While some capital will be forthcoming from official sources, including multinational organizations, the amounts will fall well short of capital requirements, implying that these economies will need to rely primarily on private capital attracted voluntarily and perhaps with little in the way of official guarantees

At the present time, the uncertainties in these evolving systems about contractual rights and the accompanying risks are

proving to be prohibitive to all but a few investors It is difficult to entice an investor to commit funds for only a few years, let alone the 20 or 30 years needed for many worthwhile projects, when there are few assurances of the prospects for earnings and ill-defined procedures for recourse in the event of default However, as I have noted, these prohibitive risks are fundamentally reducible The prompt introduction of a carefully constructed set of contract laws and complementary supervisory structure to ensure that the rules of the game will be enforced is essential to the success of the reform efforts in this part of the world, in particular, their ability to draw much needed foreign capital and managerial resources

While the fundamental law of contracts is the same in all well-functioning market systems, there are alternative models to follow among the various countries of Western Europe, North America, and Japan To be sure, political structures also must be developed that can reasonably assure investors of political stability and that contract laws will be enforced and not be capriciously overturned

Well-structured systems of contract law also will facilitate issuing public sector bonds to the domestic public in countries such as the Soviet Union The development of a bond market can be important in mopping up the overhang of liquidity that owes to years of excessive money creation, this will limit the potential for a counterproductive surge in prices of goods and services In addition, a domestic market for government debt facilitates the implementation of monetary policy by providing an effective means for adding or withdrawing reserves from the banking system Moreover, a market for enterprise debt enables these countries to wean state enterprises from central bank credit while imposing more market discipline on management

In the advanced market economies, supervision has become more complex in globalized financial markets where different legal systems apply The fundamental law of contracts is basically the same across legal systems of market economies, but there are relevant differences in areas such as bankruptcy provisions that require attention by supervisors Differences in contract law may impede the efficiency of financial markets and result in securities transactors choosing some markets over others Also, enforcement of contract law is critical, and interlinked financial markets provide more opportunities for violators to escape enforcement actions This has implications for international efforts to harmonize legal and supervisory systems and enforcement

International coordination of supervision in the banking area has made considerable progress in recent years and may be instructive for those involved in securities supervision Through the auspices of the BIS, the Basle Supervisors Committee, composed of the Federal Reserve and other central banks and bank regulators, was established in 1973 That group developed the Concordat, a statement of fundamental principles governing supervision of banks operating across borders, in 1974 Included in these principles is a framework for coordination of supervision among home and host countries Perhaps the most notable achievement of the supervisors has been the risk-based capital standards that became binding on the banks of the G-10 nations plus Switzerland earlier this year and have been adopted voluntarily by supervisors and banks from various nonmember nations Consideration also is being given by the supervisors to extending these capital standards beyond credit risk to various market risks such as interest rate and foreign exchange risks

Well-functioning market systems for securities depend on sound public policies outside of securities market supervision. Clearly, we central bankers have our part to play in ensuring such sound public policies By pursuing policies aimed at achieving price stability and fostering sustainable economic growth, we help to minimize uncertainties about the future purchasing power of our currency and boom-bust cycles in the economy

Through our role as lender of last resort we can reduce the scope for financial disturbances having spillover effects on our economies and financial markets Moreover, through our oversight role over the payments system, we play a key part in building and maintaining strong payment systems, which serve as the lifeblood of economies and financial systems By performing each of these tasks well we, too, can contribute much to confidence in our financial markets