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Statement of

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Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Foreign Operations

of the

Committee on Appropriations

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The global financial system has been evolving rapidly in recent years New technology has radically reduced the costs of borrowing and lending across traditional national borders, facilitating the development of new instruments and drawing in new players Information is transmitted instantaneously around the world, and huge shifts in the supply and demand for funds naturally follow, resulting in a massive increase in capital flows

This burgeoning global system has been demonstrated to be a highly efficient structure that has significantly facilitated cross-border trade in goods and services and, accordingly, has made a substantial contribution to standards of living worldwide Its efficiency exposes and punishes underlying economic imprudence swiftly and decisively Regrettably, it also appears to have facilitated the transmission of financial disturbances far more effectively than ever before

Three years ago, the Mexican crisis was the first such episode associated with our new high-tech international financial system The current Asian crisis is the second

We do not as yet fully understand the new system's dynamics We are learning fast, and need to update and modify our institutions and practices to reduce the risks inherent in the new regime Meanwhile, we have to confront the current crisis with the institutions and techniques we have

Many argue that the current crisis should be allowed to run its course without support from the International Monetary Fund or the bilateral financial backing of other nations They assert that allowing this crisis to play out, while doubtless having additional negative effects on growth in Asia, and engendering greater spill-overs onto the rest of the world, is not likely to have a large or lasting impact on the United States and the world economy

They may well be correct in their judgment There is, however, a small but not negligible probability that the upset in East Asia could have unexpectedly large negative effects on Japan, Latin America, and eastern and central Europe that, in turn, could have repercussions elsewhere, including the United States Thus, while the probability of such an outcome may be small, its consequences, in my judgment, should not be left solely to chance We have observed that global financial markets, as currently organized, do not always achieve an appropriate equilibrium, or at least require time to stabilize

Opponents of IMF support for member countries facing international financial difficulties also argue that such substantial financial backing, by cushioning the losses of imprudent investors, could encourage excessive risk-taking There doubtless is some truth in that, though arguably it has been the expectation of governments' support of their financial systems that has been the more obvious culprit, at least in the Asian case In any event, any expectations of broad bailouts have turned out to have been disappointed Many if not most investors in Asian economies have to date suffered substantial losses Asian equity losses, excluding Japanese companies, since June 1997, worldwide, are estimated to have exceeded $700 billion, at the end of January, of which more than $30 billion had been lost by U S investors Substantial further losses have been recorded in bonds and real estate

Moreover, the policy conditionality, associated principally with IMF lending, which dictates economic and financial discipline and structural change, helps to mitigate some of the inappropriate risk-taking Such conditionality is also critical to the success of the overall stabilization effort At the root of the problems is poor public policy that has resulted in misguided investments and very weak financial sectors Convincing a sovereign nation to alter destructive policies that impair its own performance and threaten contagion to its neighbors is best handled by an international financial institution, such as the IMF   What we have in place today to respond to crises should be supported even as we work to improve those mechanisms and institutions

Some observers have also expressed concern about whether we can be confident that IMF programs for countries, in particular the countries of East Asia, are likely to alter their economies significantly and permanently   My sense is that one consequence of this Asian crisis is an increasing awareness in the region that market capitalism, as practiced in the West, especially in the United States, is the superior model, that is, it provides greater promise of producing rising standards of living and continuous growth

Although East Asian economies have exhibited considerable adherence to many aspects of free-market capitalism, there has, nonetheless, been a pronounced tendency toward government-directed investment, using the banking system to finance that investment   Given a record of real growth rates of close to 10 percent per annum over an extended period of time, it is not surprising that it has been difficult to convince anyone that the economic system practiced in East Asia could not continue to produce positive results indefinitely Following the breakdown, an increasing awareness, bordering in some cases on shock, that their economic model was incomplete, or worse, has arguably emerged in the region

As a consequence, many of the leaders of these countries and their economic advisors are endeavoring to move their economies much more rapidly toward the type of economic system that we have in the United States   The IMF, whatever one might say about its policy advice in the past, is trying to play a critical role in this process, providing advice and incentives that promote sound money and long-term stability The IMF's current approach in Asia is fully supportive of the views of those in the West who understand the importance of greater reliance on market forces, reduced government controls, scaling back of government-directed investment, and embracing greater transparency--the publication of all the data that are relevant to the activities of the central bank, the government, financial institutions, and private companies

It is a reasonable question to ask how long this conversion to embracing market capitalism in all its details will last in countries once temporary IMF support is no longer necessary We are, after all, dealing with sovereign nations with long traditions, not always consonant with market capitalism There can be no guarantees, but my sense is that there is a growing understanding and appreciation of the benefits of market capitalism as we practice it--that what is being prescribed in IMF programs fosters their own interests

The just-inaugurated president of Korea, from what I can judge, is unquestionably aware of the faults of the Korean system that contributed to his country's crisis, he appears to be very strenuously endeavoring to move his economy and society in the direction of freer markets and a more flexible economy In these efforts, he and other leaders in the region with similar views, have the support of many younger people, a large proportion educated in the West, that see the advantages of market capitalism and who will soon assume the mantle of leadership

Accordingly, I fully back the Administration's request to augment the financial resources of the IMF by approving as quickly as possible U S participation in the New Arrangements to Borrow and an increase in the U S quota in the IMF Hopefully, neither will turn out to be needed, and no funds will be drawn But it is better to have it available if that turns out not to be the case and quick response to a pending crisis is essential