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Statement of
Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
before the
Committee on Agriculture
U S House of Representatives
May 21, 1998

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 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 had to confront the current crisis with the institutions and techniques we have.

Many argued that the Asian crisis should be allowed to run its course without support from the International Monetary Fund or the bilateral financial backing of other nations. They asserted 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, would not likely have a large or lasting impact on the United States and the world economy

They may well have been correct in their judgment, and some would argue that events over the past six months have proved them right, we have so far avoided the type of continuing downward spiral that some feared. There was and 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 have been 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. Moreover, the effects of the Asian crisis on the real economies of the immediately affected countries, as well as on our own economy, are only now just being felt.

Opponents of IMF support for member countries facing international financial difficulties also argued that such substantial financial backing, by cushioning the losses of imprudent investors, encourages 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.

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 on the part of governmental authorities. At the root of the problems has been 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, has played an important 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 financial support has come to an end. We are, after all, dealing with sovereign nations with long traditions, not always consonant with market capitalism. But my sense is that there is a growing understanding and appreciation of the benefits of market capitalism as we practice it, and that what is being prescribed in IMF-supported programs fosters their own interests.

Similarly, it is a reasonable question to ask whether the U.S. authorities should not seek greater assurance that the ongoing process of reform in the IMF's policies and operations will produce additional concrete results before we agree to augment the IMF's resources. I have reason to believe that the management and staff of the IMF are committed to a process of change. We face a somewhat more difficult task in convincing the IMF's membership as a whole of the need for change. However, I am confident that our leverage in this regard would be reduced if the United States failed to agree promptly to the proposed increases in the IMF's resources.

Accordingly, I continue fully to 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. Although the tendency in recent months toward stabilization in the East Asian economies is encouraging, clearly those economies are not out of the woods as recent events attest. Moreover, we have not yet put in place the strengthening of the international financial architecture that would enable us in the future to place less reliance on the IMF to deal with potential systemic crises. Thus it is better to have the IMF fully equipped if a quick response to a pending crisis is essential.