Commentary: Why Is Financial Stability a Goal of Public Policy?

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Andrew Crockett's paper ranges broadly and sure-footedly over the controversial issues with which it deals, thereby providing an excellent opening paper for this conference—on a topic which could not be more timely.

Andrew's answer to the question posed by the title of the paper is that financial instability and macroeconomic instability are closely intertwined, and that each may cause and/or exacerbate the other. That is sufficient reason for financial stability to be a goal of public policy.

I will comment very briefly on one or two of the issues covered in Andrew's paper, but direct the bulk of my remarks to an area that he touched but did not expand on—the international dimension of efforts to deal with financial instability. I thus anticipate some of the discussion of the third paper in the conference, by Barry Eichengreen and Richard Portes.

Stability of institutions and prices

Andrew draws a distinction between the stability of institutions and the stability of markets, meaning by the latter the stability of market prices. Institutions need to be designed for safety, but as in the case of automobiles, there is a tradeoff between the safety

features and the ability to do the basic job—in the case of automobiles, transporting people and goods; in the case of financial institutions, financial intermediation. Even if some financial institutions could be built for absolute safety, for example narrow banks (about the benefits of which I am skeptical), not all financial institutions could or should be built to survive the most extreme macroeconomic shocks. That means that even as we need to work to strengthen the financial system, we should expect occasional difficulties in financial institutions and sometimes financial crises.

In discussing the stability of markets, Andrew talks mainly about price behavior. There is also, of course, much that can be done to strengthen the institutional infrastructure of markets, particularly with regard to the provision of information, accounting standards, and settlement rules and practices. But even in the best of markets, for instance the foreign exchange and U.S. stock markets, prices will occasionally reach levels that worry policymakers.

Andrew asks whether policymakers have a legitimate right to worry about prices set in well-functioning markets, concluding with a muffled yes, but doubting that those worries are likely to have much effect. It would be irrationally exuberant at a conference hosted by the Federal Reserve System to conclude that policymakers do not have a right to worry about asset prices. The long-lasting aftereffects of the Japanese asset price bubble of the late 1980s, and the extraordinary movements in the yen-dollar exchange rate in 1995-96, were surely causes for valid concern by policymakers.

Is there anything useful to do besides worry? At one time selective credit controls could have been aimed at particular asset markets, but such controls are now either no longer available or in disfavor. In some countries it remains possible for the central bank to tighten regulations relating to lending for real estate or other categories of assets. An alert and strong supervisory authority would be able to warn financial institutions under its aegis against becoming too extended in particular directions. Given the frequency with which excesses in real estate markets are associated with subsequent difficulties for financial intermediaries, this market bears continual

watching and, when signs of excess emerge, and where regulatory or prudential controls are available, will benefit from timely policy actions. In the case of foreign exchange markets, well-timed coordinated intervention has sometimes worked—perhaps because the markets needed a concrete demonstration of the authorities' views on where the exchange rate should be. And all central bankers apply an open-mouth policy on occasion.

All this stops short of changing the thrust of monetary policy to deal with asset prices at a time when business cycle indicators such as inflation and unemployment would not demand a change in policy. But if asset prices get significantly out of line, monetary policy may have to respond, for the consequences of allowing the asset price inflation to continue may be a very long and painful period of readjustment when the bubble would otherwise have burst.

International efforts to improve financial stability

One important method by which the international community contributes to financial stability is through the setting of international standards, notably including those set by the Basle Committee of Banking Supervisors, the International Organization of Securities Commissions (IOSCO), and the International Accounting Standards Committee (IASC).

In the last year there has been a flurry of activity, stimulated in part by Morris Goldstein,[1] to strengthen international banking standards, particularly for emerging markets. This has led to the Basle Committee's "Core Principles for Effective Banking Supervision"—twenty-five principles agreed with supervisors from emerging-market countries. The staff of the International Monetary Fund (IMF) has prepared a paper called "Toward a Framework for Financial Stability," which sets out many of the lessons they have learned from their experience in many different countries, and also presents the Basle Committee's Core Principles and important reports by IOSCO and the IASC in appendixes.

Now the international community faces the challenge of getting

the Core Principles implemented. That is primarily the task of the domestic monetary and supervisory authorities in each country, but dissemination of the standards by the Basle Committee, the IMF, and the World Bank, as well as technical assistance from other central banks and the international financial institutions, can certainly help. And of course, the effort to strengthen financial systems will have to extend beyond banking systems to include other financial institutions and markets.

Let me turn now to the role of the IMF in promoting financial and macroeconomic stability. We do this in four ways. First, through *surveillance*. This takes the form of comprehensive analytical and descriptive reports to the executive board of the IMF—and through the board to all member governments—on economic developments in our 181 member countries and in the international economy. The regular (usually annual) Article IV report on each country is the basic vehicle for Fund surveillance over individual member countries; the twice-yearly *World Economic Outlook* and the annual *International Capital Markets* report are the main vehicles for surveillance over the world economy. In recent years, the board has shown increasing interest in financial sector issues and particularly banking difficulties in member countries, and the emphasis on these issues in Article IV and other reports has shifted accordingly.

Second, through *information provision*. In addition to the Fund's regular statistical publications, of which *International Financial Statistics* is best-known, we introduced post-Mexico the Special Data Dissemination Standard (SDDS) and its associated Dissemination Standards Bulletin Board (DSBB) to make important market-relevant data available on-line. *Recent Economic Developments*, a factual background paper prepared for each annual Article IV consultation with a member country, can be made public unless the country specifically objects, and most countries consent. The board has not agreed to the publication of the Article IV policy report, but in the last few months, the Fund has begun to make available so-called Press Information Notices (PINs), summaries—edited only to remove market-sensitive information—of the chairman's summing-up of the discussion of the Article IV report. While release of the PINs is

voluntary, a surprising number of countries have agreed to their publication. All this is evidence of the increasing openness of the Fund, an issue to which I will return.

Third, the Fund *lends*, both to help cushion the shocks and costs of adjustment of individual member countries, and in part to try to reduce contagion effects. This lending is always conditional, and the conditions often include measures to reform the banking and financial systems.

And fourth, the Fund provides *technical assistance* to member countries that need it.

Mexico and Thailand

After Mexico, the international community, including the Fund, drew lessons to try to reduce the probability and expected costs of future crises. On the Fund's part, in the first instance we saw a need to tighten our internal procedures, to ensure that we monitor potential crisis situations closely, and stay in close touch with market developments. Second, it was widely agreed that we needed to improve the information countries make available to markets. Third, we recognized a need for more frankness in Fund reports to countries and to the executive board—less "Fundspeak" and more plain English. And finally, we saw a need for a more intense dialog with member countries that might be heading for a crisis.

All this has been done: our internal procedures have been changed; the DSBB is open on the Internet with information for 35 subscribing countries including direct hyperlinks to country data sites in an increasing number of cases (twelve so far); Fund reports are more readable and blunt; and the management of the Fund is now in close and frequent touch with members whose economies are in potential trouble—we report to the board, write letters, call, and occasionally visit.

How did this work in the case of Thailand? Thailand has subscribed to the SDDS, but has availed itself of the transition period

through yearend 1998 that temporarily permits a country to subscribe without fully meeting the requirements of the SDDS. It also turns out that one of the key variables that would have been needed to evaluate Thailand's situation—its forward foreign exchange commitments—is not so far required under the SDDS. Nonetheless, we were actively concerned about the vulnerabilities of the Thai economy for well over a year, intensively so for at least the last six months. We wrote and talked to the authorities, urging increased flexibility of the exchange rate and immediate measures to deal with financial sector problems.

Why could we not prevent the crisis? The lack of data on the open forward book of the Bank of Thailand did play a role: certainly the IMF would have been more effective in urging action had we known how much forward intervention there had been; and the markets would likely have forced action far sooner had they known it. But that is not the most important factor: the key problem was that the Thai government was weak, unable to take action until forced to do so by a crisis. In addition, the markets kept on financing Thailand for too long, until well after the fundamentals had changed.

In thinking through the lessons of Thailand for crisis prevention, it is important to realize that the IMF's surveillance provides information to the official sector, and not to markets. We operate as an adviser to member governments, and have privileged access to their thoughts and information. We can use that information to discuss issues with the government involved, and through our executive board and other contacts, with the official sector of the international community. But we cannot go public, because if we did so, we would lose our special access to information and our advisory role, and would become just another rating agency.

When the IMF believes it sees a crisis coming, it may warn and cajole the government concerned, but it cannot force a sovereign government to take action. Why not go public, thereby enlisting the markets in the cause? That is a risky choice, both because it may cause the very crisis it seeks to prevent, and because the Fund may be wrong, and thereby cause a crisis that would not otherwise have

happened. Further, if the Fund did go public, its ability to work with the government concerned after the crisis broke would be severely impaired, and its ability to issue accurate warnings in future crises would also be impaired, for the reasons set out above. Of course, it may be possible to send hints, but that is a risky business, albeit one that could be engaged in extreme conditions.

Crises like those of Mexico and Thailand are evidence that the markets recognize a major problem when they see one. But in each case the recognition came late, and then very hard. Although critical pieces of information were missing in both cases, it is difficult to make the case that the absence of information justified the market's delays in reaching conclusions. The provision of information alone does not guarantee that the markets will reach the right conclusions. There is a difference between having information and realizing what it implies, and it is the latter—understanding the true situation—that is the critical requirement. This is part of the reason for the herding behavior that is often observed in speculative markets. While I share the emphasis on the need for better information in Frederic Mishkin's paper for this conference, we need to recognize that the ability to analyze information and reach the right conclusions will remain limited, and that crises will therefore happen however much information is improved.

In both the Mexican and Thai crises, there were important *contagion effects*. Eichengreen, Rose, and Wyplosz define contagion as existing when the likelihood of a crisis in one country is increased, holding all other relevant factors constant, by the existence of a crisis elsewhere.[2] They concluded that contagion effects have been present in a number of past crises, and I am sure that a future analysis along their lines will confirm that contagion effects were present in Southeast Asia in the fall of 1997.

Some contagion does make sense. For instance, once Thailand had devalued, the equilibrium exchange rates of its neighbors and competitors probably also needed adjustment. In addition, those exchange rates also needed to be adjusted because of the appreciation of the dollar over the past year.

It could also be argued that the vulnerability of the other Southeast Asian economies to attack justified the attacks. Here I must confess to a suspicion that there are few countries that are not vulnerable to a massive attack on their currency, for the very measures needed to deal with the attack—higher interest rates and devaluation—weaken the banking system, thus at least partially justifying the attack. These could be cases of self-justifying attacks, which produce multiple equilibria. That is another reason for the concern over financial instability that is the subject of Andrew's paper.

Concluding remarks

As globalization of capital markets continues apace, both the benefits and potential risks of international financial liberalization increase.[3] To help deal with the risks, the Articles of Agreement of the IMF are likely to be amended to make the liberalization of the capital account an explicit goal of the Fund—whose purpose will be to help ensure that liberalization takes place in an orderly fashion.

That means that the conditions set out by Andrew in his paper will need to be in place, that the country's financial system including its prudential controls have been strengthened to international levels, and that macroeconomic stability is close at hand. Those are the circumstances under which countries are most likely to reap the gains of integration into the global capital markets.

They are also the conditions for reducing the frequency of international financial crises. Even so, we should not expect that financial crises can be entirely avoided, and will need to put in place measures to deal with them when they do occur.

Author's Note: Views expressed are those of the author and not necessarily of the International Monetary Fund.

Endnotes

[1]See Goldstein, Morris, *The Case for an International Banking Standard*. (International Institute of Economics, June 1997).

[2]"Contagious Currency Crises," presented at the CEPR/ESRC Global Economic Institutions Programme Conference, Cambridge, England, July 1997.

[3]I address these issues in more detail in "Capital Market Liberalization and the Role of the IMF," IMF paper, (September 1997).

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