
Bank for International Settlements – Annual Report

The 68th Annual General Meeting of the Bank for International Settlements, in which the Reserve Bank of Australia is a shareholder, was held in Basle, Switzerland, on 8 June 1998. The following are excerpts from the BIS Annual Report.

Crisis Prevention and Crisis Management

The fact that financial and exchange rate crises have continued to occur, and indeed have become more frequent in the 1990s, clearly indicates that preventive measures to date have been inadequate. Nevertheless, a great deal of work has been undertaken in recent years and considerable progress has been made in some areas. The Group of Seven summit communiqués from Halifax, Lyon and Denver gave significant impetus to such work, as have the documents issued after the Birmingham Summit.

If preventive action is to be taken to head off a crisis, market participants and regulatory authorities must first have adequate access to information likely to be useful in predicting such a crisis. Over the past year, an increasing number of countries have committed themselves to the IMF's Special Data Dissemination Standard. Moreover, agreement has already been reached on a number of useful changes (among them, broader country coverage, allocation

according to ultimate risk and quarterly frequency) to the BIS semi-annual data recording the maturity, sectoral and nationality distribution of international bank lending. At the same time, it must be recognised that better information is a necessary, but in itself not sufficient, condition to prevent crisis. What is also needed is the vision to imagine crises and the will to act pre-emptively. The Asian experience makes this very clear. In spite of the ready availability of BIS data showing the increasing vulnerability of some of these countries to a sudden withdrawal of short-term international bank loans, the volume of these loans simply kept on rising. Other evident problems, such as growing current account deficits and declining rates of return on investments, were similarly ignored. This illustrates that the use made of information is every bit as important as its mere availability.

The international community, led by the International Monetary Fund, sought to stabilise the situation in Asia with successively larger packages of liquidity support. These were combined not only with traditional demand-side conditionality and financial reform, but also with supply-side measures to support longer-term growth. In some cases, efforts were also made to encourage foreign banks to roll over or restructure the maturing liabilities of Asian borrowers. While some have questioned the appropriateness of certain of these policy initiatives, as well as the way in

which they were to be implemented, the complexity and even novelty of the task being undertaken by the Fund should not be underestimated. Many of the countries affected did indeed have relatively sound fiscal policies but their exposure to a deterioration in market confidence on other grounds was nevertheless exceptionally great. Moreover, this was the first crisis in the postwar period featuring the combination of banks as the principal international creditors and private sector entities as the principal debtors. The principles of how to manage and resolve a crisis of this sort were not known in advance and, indeed, are still under discussion. In this area, as with crisis prevention, it will take some years before all the lessons have been understood and probably longer before they have all been accepted and applied. With this caveat clearly in mind, the conclusions below nevertheless turn to some of the possible policy prescriptions suggested by the many surprising events of the period under review.

The Mexican and Asian crises were similar in that balance of payments difficulties interacted with weak domestic financial systems to calamitous effect. However, they differed in that the former was characterised by excessive consumption and the latter by excessive investment. Moreover, the Mexican crisis primarily involved a sovereign debtor and non-bank creditors while the Asian crisis has primarily involved private sector debtors and bank creditors. While the fact that no two crises are alike complicates the search for measures both to prevent and to resolve crises, some positive steps can still be recommended.

Crisis prevention demands, above all, healthy domestic financial systems. While the Basle Core Principles for Effective Banking Supervision provide a crucial building-block for improvements in this area, implementation will be a challenge. There is currently a great shortage of trained personnel among banks and supervisors alike, which will take a significant educational effort and require many years and considerable resources to rectify. Perhaps an even more difficult problem is political resistance to reform from those who have thus far benefited from the existing system. If market

discipline, as well as peer pressure from supervisors and politicians in more progressive countries, do not suffice to overcome such obstacles, the withdrawal of rights of establishment for banks from jurisdictions with inadequate prudential standards might eventually have to be contemplated.

It may also be that international standards will be required in other areas if healthy financial systems are to be assured. Committees reporting to the Group of Ten Governors at the BIS are currently assessing the need for and the feasibility of developing such guidelines or principles in a number of areas. One obvious issue is the need for clear, internationally comparable and transparent accounting standards. Without clarity as to what corporate accounting numbers mean, it is impossible to assess the quality of credits or the health of the banks that have granted those credits. Confusion as to what the banks' own accounts might mean adds another unwelcome layer of opacity in many emerging market and even a few industrial countries. Both of these problems need to be urgently addressed. More broadly, there is a great need for more transparency and more disclosure about the financial activities of both the private and the public sectors in all countries.

Crisis prevention, however, goes beyond having a sound financial system at the outset. It also requires adequate indicators of any threat to macroeconomic stability, whether arising from new developments in the banking system or elsewhere, and a set of incentives to ensure that those who should act do so before the eruption of a crisis. However, the indicator problem is a thorny one. Dangerous excesses generally build upon good fundamentals, and knowing when the line has been crossed is not easy. While a number of empirical models have been developed for predicting both balance of payments crises and banking crises, their common shortcoming is the frequency with which they predict crises that never happen. Uncertainties of this sort may help explain the reticence of public authorities to make predictions in this regard and the unwillingness of rating agencies to respond promptly to early signs of trouble.

The issue of incentives to act pre-emptively is equally thorny. Consider the Mexican and Asian crises and the application of market discipline. In both cases money continued to flow in, even though widely available statistics made it clear that the stock of tesobonos and other short-term debt, in the former instance, and the level of short-term international bank lending, in the latter, had risen dramatically. These data were generally ignored, although in the Asian case there is also some evidence that non-bank financial institutions did withdraw funds before the crisis hit. Studies are urgently needed to understand the mechanisms which led banks to further increase their exposure to countries already subject to warning signals, including in some cases warnings emanating from within the banks themselves. One possible answer is that the sums involved were relatively small from the perspective of individual investors, even if of dangerous size from the perspective of the recipients. Should the existence of such externalities be proved, this would in itself provide an argument for some form of public policy intervention.

The public sector must also question whether its own incentive structures need improvement in at least three areas. One possible reason for the magnitude of international bank lending in Asia was the existence of public safety nets for both debtors and creditors which seemed to attenuate virtually every form of risk. With most foreign loans being made to domestic banks, normal credit risk was reduced by the expectation of their governments' support. Concerns about liquidity risk may have been eased by the series of liquidity support measures which had been organised earlier by the international financial community, however necessary those measures were at the time. And finally, the fact that most such Asian loans were short-term and denominated in foreign currency lowered perceptions of market risk as well.

A second question for the public sector is whether the detailed specifications of regulatory capital ratios made short-term interbank lending look particularly attractive.

If so, the various arguments for such specifications need to be reassessed. And finally, it may be asked whether the proper incentives are in place, in both lending and borrowing countries, for supervisors themselves to act expeditiously before a crisis erupts. Analogous to monetary authorities in the modern world, supervisors need a clear and consistent mandate, powers to act in pursuit of their objectives, and public accountability for their actions. In the absence of these conditions, and they are by no means present everywhere, supervisors too may be tempted to exercise forbearance.

Even though the Asian crisis is not yet definitively over, some issues pertinent to the problems of crisis management can already be identified. The first is the need for the private sector to take some responsibility for the ongoing provision of credit to customers to whom they had previously lent all too freely. This is not just to avoid moral hazard problems, but also to acknowledge a simple reality. Capital flows have now grown so large that public sector funds simply cannot fill all the potential gaps that might open up as capital inflows reverse. Thus, some better means of burden-sharing will be required. A second issue begins with the recognition that the threat of a unilateral stay on payments would help bring banks to the negotiating table earlier. Such a threat would be more credible if the international financial institutions were to announce in advance their willingness to provide further needed financing by 'lending into arrears' to countries whose domestic policies were deemed acceptable. The Ministers and Governors of the Group of Ten have endorsed the suggestion that the IMF should reconsider its policies in this respect. Finally, after the Mexican crisis the G-10 Deputies made a number of recommendations designed to facilitate crisis management. None of these has so far been implemented, which raises the question of what could and should now be done in this regard.

Resolving issues pertaining to crisis management will continue to be important since measures for crisis prevention will never

prove totally reliable. This is not a statement of despair but of realism. Hopefully, it will encourage policy-makers not only to redouble their efforts to promote price and financial stability, but also to plan their reactions in advance should events fail to unfold as they

might desire. Given the troubling way in which economic, political and social factors can sometimes interact, it is simply not prudent to assume that everything will turn out for the best. ✕