5-26-2008

Remarks by Assistant Secretary Clay Lowery to the Foreign Correspondents Club of Japan

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U.S. DEPARTMENT OF THE TREASURY

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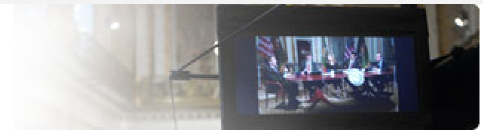

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HP-1019

Thank you for the opportunity to speak with you today. Many of the speeches given by Treasury officials concern financial sector problems, and in the past a number have addressed problems in the Japanese financial sector. Today our speeches are more often about financial turbulence in the United States and what we are doing to address it. Today I'd like to step back a bit and talk about some lessons we have learned from episodes of financial turbulence over the past twenty years, how these lessons relate to recent global financial market turmoil, and what we are learning from recent events.

I will divide my remarks into four sections. First, what are the sources of financial turbulence. Second, what have we learned about dealing with financial sector turbulence. Third, what have we learned from past episodes about strengthening financial systems and avoiding future problems. Finally, why is financial sector innovation so important and why will the tensions between financial sector innovation and regulation remain.

Sources of Financial Sector Turbulence

Charles Kindleberger, the economic historian, has called financial crisis a "hardy perennial." Financial services differ from most other industries by explicitly linking the future to the present – promises to pay in the future, the value of assets in the future, insurance against future events. It is at its heart about uncertainty and risk, about expectations and confidence, and subject to shifts between exuberance and fear.

Sometimes that exuberance, which may be unsustainable, is driven by innovations like the railroads, or opening up new territories to exploration like the South Sea Corporation. Or the innovation can be in the financial sector itself – as in our recent case of securitized investment vehicles (SIVs) and specialized products such as collateralized debt obligations.

On the other hand, financial turbulence may arise from market movements rather than exuberance. For example, the U.S. Savings and Loan (S&L) crisis had its roots in a substantial maturity mismatch between assets and liabilities and a prolonged period of high nominal interest rates which, following financial deregulation, drove up the short-term funding costs for thrift and other financial institutions. Roughly three-quarters of thrift assets comprised fixed rate, low-yielding mortgages and mortgage-backed products, while almost all thrift liabilities were short-term deposits subject to rising interest rates.

Japan's financial crisis in the 1990s had its origins in an equity and property bubble that began in the late 1980s. Growing bank exposure to the real estate sector coupled with the widespread use of property as loan collateral multiplied banking sector risk. When growth slowed and property prices fell after the bursting of the bubble, Japan's banking sector came under increasing strain. Bank holdings of corporate equity, a part of which counted in bank capital, fueled additional lending when equity prices were rising. But when equity prices fell along with property prices, the squeeze on bank capital worsened the problems of Japanese banks.

Responding to Financial Turmoil:

Recognizing Losses, Prompt Regulatory Action, and Restoring Healthy Balance Sheets

We need to look to the past to understand the causes of financial turbulence so as to try to prevent future episodes. But we also need to need to draw lessons from the past so as to try to resolve bouts of turbulence once we are in them. One thing that we have learned from our own experience – and it has been an expensive lesson – is the importance of acting quickly to deal with financial sector difficulties. This means having accounting rules that require financial institutions to recognize losses quickly and a supervisory system that requires prompt action to restore balance sheet health. This is what we failed to do in our own Savings and Loan Crisis in the 1980s, but what has characterized our response to the current credit market turmoil.

In Japan, as in the U.S. S&L crisis, delay in recognizing and dealing with banking sector weakness led the problem to grow over time. The solution to Japan's banking crisis eventually came from a combination of mark-to-market accounting rules, stricter evaluation of loan quality, workout or sale of distressed assets, and increased bank capital through public funds and the private market.

In contrast, Sweden's banking crisis serves as an example of how prompt and effective action can limit the cost of financial crises, both in terms of their drain on public resources and their drag on economic growth. Problems in the banking sector initially emerged in 1991 but by 1994, the Swedish banking system already had returned to profitability. Early on, in autumn 1991, it became apparent that banks, experiencing real estate-related losses, would not be able to meet the higher capital ratios required by Basel I. Early recognition of the need for extensive action and broad political consensus played critical roles in resolving the crisis. The Swedish government quickly evaluated the situation of its banks, set up a fund to strengthen those that were viable and resolve those that weren't, and established two institutions to accept and resolve distressed assets.

Mature economies' experiences with banking failures teach us to appreciate the need for strong risk management, accounting and valuation that accurately reflects true financial conditions, and prompt disclosure of information to strengthen market discipline. Authorities understand the need to step in promptly to supply liquidity to markets, to protect depositors, to liquidate failed institutions, and to press banks to recognize losses, and merge or raise new capital. Returning banking systems to financial health has been fastest and most successful when authorities promptly address problems, strictly limit lender of last resort function, use firm deadlines for resolution, and ensure the appropriate incentives to owners and managers to mitigate moral hazard.

The lessons from our own S&L experience, as well as those from Japan, Sweden, and other countries have helped us shape our policy response to the current financial turmoil in the United States. Minimizing the impact on the real economy has been a guiding principle, as has been prompt, decisive action.

As financial market turmoil surfaced last August, policymakers in the United States acted quickly to stabilize markets, reduce the impact of the turmoil on the real economy, and address underlying regulatory and policy weaknesses. Treasury Secretary Paulson, at the forefront of U.S. government efforts, has worked to ensure a comprehensive, timely and appropriate response. We have sought to avoid overreacting with regulations or policy responses that would stifle innovation or distort the natural self-correcting forces of markets.

Secretary Paulson and other authorities have urged banks to promptly recognize and report losses, and raise additional capital as needed. Many global financial institutions have done so – reporting subprime-related losses of over $300 billion and raising additional capital of more than $200 billion.

In addition to prompt action in the financial sector, there is macroeconomic policy. In the United States, the Administration has worked with the Congress to help soften the negative impact of these events on the real economy, through fiscal policy and a series of initiatives to help families stay in their homes. In practically record time, the U.S. Government has already begun implementing a $150 billion economic stimulus package that will support consumer and business spending as we weather the current economic slowdown.

The U.S. Federal Reserve and other central banks have taken focused, and sometimes coordinated, actions to protect the financial system from severe disruption by ensuring that markets have access to financing. Already, we have seen some indication that this combination of actions is beginning to have the desired effect, as markets appear to be gaining confidence and the availability of credit has improved modestly.

Strengthening Financial Systems and Avoiding Future Turbulence

We have come a long way from past experiences of bank runs, financial panics, and depressions. In many ways, it is the lessons learned from past events that have helped make financial turmoil less likely to occur and reduced their impact. However it is important that we continue to analyze, draw lessons, and implement measures based on those lessons.

For instance, drawing on another event, the Asian Financial Crisis ten years ago demonstrated that a balance of payments crisis could become a banking system crisis when there are fixed exchange rates and internationally mobile capital, providing valuable lessons about the importance of flexible exchange rate regimes. Openness to capital flows also requires cultivating regulatory regimes, institutions and policies that support stronger risk management, flexibility and adaptability.

The Asian Financial Crisis also revealed the pitfalls of over-reliance on the banking sector for financial intermediation and the great value of financial sector diversification, particularly well-functioning bond markets. Bond markets provide important price signals for the economy, by establishing market-determined interest rates over various maturities that accurately reflect the opportunity cost of funds. Bond market creditors also transfer risk to those who are willing to bear it and exercise market discipline upon issuers.

Since the Asian crisis, bond market development has become a priority around the world – starting with a number of initiatives in APEC, then the Asian Bond Market Initiative, and most recently the G8 Action Plan for Developing Local Bond Markets in Emerging Market Economies and Developing Countries.

Bond markets have developed rapidly in emerging market economies since the Asian Financial Crisis, and those economies are more resilient as a result. Domestic securities outstanding have grown to about $6 trillion, nearly six times that of ten years ago. Local currency debt now accounts for about two-thirds of total emerging debt held and traded by international investors, which is a little less than a 70 percent increase from the beginning of the decade. It is measures like these – deduced from past lessons – that are contributing factors to emerging market spreads not "blowing out," even during these turbulent times.

Although the United States is still grappling with the subprime financial turmoil, we have already begun to draw lessons for strengthening our financial system in the future. The President's Working Group on Financial Markets in March recommended changes to mitigate systemic risk and restore investor confidence to facilitate stable economic growth. These recommendations are to:

Reform the mortgage origination process; enhance disclosure and improve the practices of sponsors, underwriters, and investors with respect to securitized credits; reform the credit rating agencies' processes for and practices regarding rating structured credit products; ensure that global financial institutions address weaknesses in risk management and reporting practices; ensure that prudential regulatory policies applicable to banks and securities firms, including capital and disclosure requirements, provide strong incentives for effective risk management practices; and enhance the OTC derivative market infrastructure.

These recommendations are being implemented now.

International Responses

From the outset, it has been clear that the interconnectedness of today's markets required an international, as well as domestic, response. U.S. financial officials have worked closely with counterparts in major economies around the world to address market instability. The Financial Stability Forum (FSF), which brings together the supervisors, central banks, and finance ministries of major financial centers, has been critical to this effort. The FSF has released a number of recommendations that echo and complement efforts underway in the United States. Implementation already has begun.

The current turmoil in U.S. financial markets has also underscored the need to revise and strengthen our system of financial sector regulation. Long before our current challenges, Secretary Paulson had launched a broad Capital Markets Competitiveness Initiative. Work has proceeded in a variety of areas such as accounting and auditing, disclosure, and financial education.

Treasury concluded in its Blueprint for a Modernized Financial Regulatory Structure that the optimal financial regulatory model mirrors the reasons we regulate: market stability, safety and soundness associated with federal guarantees, and consumer and investor protection. This proposal includes a market stability regulator, prudential financial regulator and business conduct regulator. We believe that this approach will foster innovation, mitigate risk, and enhance the competitiveness of America's capital markets.

In Japan, we see the plans for enhancing the competitiveness of its financial markets. The cornerstone of this work is the Financial Services Agency's broad vision for improving the regulatory environment through enhancing the transparency and predictability of regulatory actions. One of the fundamental lessons we have learned is the importance of regulatory transparency, predictability and consistency. Comprehensive steps to support market efficiency by relaxing firewalls where appropriate, enhancing the competitiveness of exchanges, and strengthening market discipline will serve Japan well.

Financial Sector Liberalization and Innovation and the Challenge for Financial Sector Policy and Regulation

If financial sector turbulence is a recurring feature of financial systems, what should we conclude about the value of financial sector innovation? In particular, what lessons should emerging markets now reforming their financial systems draw from the recent financial market turmoil and past crises? Is this a reason to slow financial sector reform, liberalization, and opening?

I strongly believe the opposite is true.   Slowing down financial sector reform is not a recipe for avoiding crises, but it is a recipe for slowing growth.   Strong, sustained economic growth, particularly in today's economy depends critically on efficient, competitive, and innovative financial systems.   And robust, resilient financial systems depend on sound macroeconomic policies; legal frameworks that establish transparent, enforceable bankruptcy provisions; and strong, independent financial regulation.   In addition, financial sectors that are open to competition and new entry – both domestic and foreign --underpin financial sector development, innovation, and economic growth.

In fact, the importance of openness to competition and new entry goes well beyond financial services.   Open investment regimes are critical to maintaining and enhancing competitiveness. Japan has been the beneficiary of inward foreign portfolio investment and the ability of its firms to invest overseas.   But Japan still lags far behind most OECD countries in inward investment as a percentage of GDP, and there concerns among investors that Japan may not be fully committed to attracting FDI.   It is therefore important that Japan sends a clear message that it is open to foreign investment, especially in a period in which open regimes are being challenged by rising protectionist pressures around the world.

Financial markets continually evolve and innovate, and at an accelerating pace in this era of globalization.   Today's innovations will often become tomorrow's staples of financial services.   For instance, broad market index funds were once highly innovative but now are standard components of pension plans around the globe.   Financial regulation needs to keep pace so that our markets remain transparent, robust and internationally competitive – and resilient enough to withstand the inevitable volatility that investors face from time to time.   Financial sector regulation will always be responding to financial innovation, and we will always be striving to improve financial policy and regulation to deal with the financial sector as it evolves.

Conclusion

The nature of financial markets, with their dependence on confidence and expectations, and the rapid pace of innovation mean that financial market authorities will never succeed at removing all risk of turbulence or crisis.   But a combination of accurate accounting and disclosure, market discipline, a determination to act quickly to resolve problems, and a willingness to examine and learn from past crises is the best way to limit the extent and the frequency of financial market turmoil.

Thank you.