

PERSPECTIVES ON FINANCIAL CRISES:  
WHAT HAVE WE LEARNED FROM THE EVENTS OF RECENT YEARS?

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It is a distinct pleasure to be invited to speak at this year's Hyman Minsky conference. Throughout his career, Hy Minsky emphasized the importance of understanding the linkages between the institutional structure of the financial system and the macro economy. For many years, such an emphasis was, shall we say, out of fashion, both in macroeconomic modeling and in policy discussions. In recent years, however, dramatic changes in financial markets and a wave of financial crises around the world have brought renewed interest in the role that the financial system plays in economic growth and in macroeconomic stability.

Today, I would like to share my perspective on some of the broad lessons that can be drawn from the events of recent years. In my view, there are important policy implications both for the supervision and regulation of financial markets and institutions, and for the Federal Reserve's role in maintaining financial stability.

#### The Importance of a Strong and Stable Financial System

Let me begin by taking a closer look at the relationship between financial structure and overall economic performance. In normal times, it is easy to overlook the contribution the financial system makes to the economy. Indeed, in the U. S., the process of transferring funds from savers to investors through the banking system and through capital markets is so seamless and efficient that we often take it for granted.

Such is not the case elsewhere. In fact, one way we have gained a greater appreciation for the importance of the financial system is by comparing economic performance across countries with different financial systems. Over the past several years, there is increasing evidence, drawn from the experience of newly emerging market economies in Eastern Europe, Asia, and Latin America, that financial structure is a key feature distinguishing relative economic performance. Countries with a fragile financial system, a weak legal and regulatory structure, and state ownership or control of financial institutions are generally more prone to crises and show weaker economic performance.

The second way that we have come to appreciate the role of financial institutions is in times of financial stress when the intermediation process no longer functions effectively and when falling asset prices undermine household and firm balance sheets. Financial crises can affect the economy in a number of ways. Borrowers experiencing a sudden increase in the cost or a reduction in the availability of credit may be forced to curtail their spending, resulting in a contraction in output and employment. In addition, changes in asset prices may generate changes in wealth that affect spending directly as well as influencing consumer and business confidence.

Over the past recent decades, we have seen an increased incidence of financial crises around the world. Indeed, in just the past twenty years, more than two-thirds of IMF member countries have experienced one or more financial crises. Many of these crises have had severe economic consequences in terms of lost output and employment. In each of the affected countries, policymakers have faced the dual challenge of managing the crisis while also developing institutional reforms to create a more stable financial system for the future.

### Five Lessons from Recent Financial Crises

While all financial upheavals have unique features, they also have important similarities, which enable us to draw some general conclusions about appropriate ways to manage them and inhibit their recurrence. As I look back on those that have occurred in the U. S. and other countries, I would suggest five general lessons to be gained from the experience.

#### Lesson 1

First, financial market regulation must be dynamic, not static, and must adapt to a changing financial environment. It is unrealistic to believe that a regulatory framework designed for a particular financial structure will continue to be effective when that structure changes. A good example is the growth of capital markets and increased importance of institutional investors in the U.S. financial system, a development that is bringing about far-reaching changes in how we regulate banks and other traditional financial intermediaries.

Moreover, there is an ongoing interaction between regulation and those institutions that are regulated. Regulation changes incentives, which causes further changes in institutions' behavior and the need to further modify regulation. Classic examples are the response of banks to interest rate ceilings, reserve requirements, and capital standards. In each case, banks have developed methods of reducing or avoiding the costs associated with the regulations. Regulators, in turn, have been forced to continually modify, and in, some instances, eliminate the regulations. This process is unlikely to change going forward, and so I suggest prudence requires considerable flexibility in regulatory approaches as we attempt to keep pace with changing financial markets and institutions.

#### Lesson 2

The second lesson is that, while regulatory change is necessary, it is also difficult and costly. Indeed, in the short-run, regulatory changes can be destabilizing rather than stabilizing. In the U. S., we saw this in the savings and loan industry in the early 1980s when we removed deposit interest rate ceilings and expanded lending powers without making appropriate adjustments in supervisory oversight. Similarly, a common factor in a number of financial crises in developing economies in recent years was a decision to open domestic financial markets to international capital and competition without strengthening the domestic banking system. These events suggest that regulatory change must be carefully managed and, in some instances, gradually implemented so as not to become a destabilizing factor in the economy.

### Lesson 3

The third lesson is that once in a financial crisis there are no easy solutions for dealing with it. Recent examples include Japan and some developing economies. Over the past decade, weakness in the Japanese banking system has had a serious impact on the performance of the Japanese economy, and the cost of financial disruptions in some developing countries has exceeded 50 percent of GDP.

When the intermediation process breaks down, as in Japan, what is needed is a restoration of bank lending. However, for a number of reasons, this is difficult to accomplish. In many respects, regulators still do not have the information or the tools to resolve a severe crisis that affects a large part of the financial system. Many times banking authorities do not have the necessary information that would allow them to distinguish liquidity-impaired from insolvent institutions in a timely manner. Moreover, there is sometimes a tendency for supervisory actions to be overly restrictive, based on a worst-case scenario that does not accurately distinguish between degrees of problems in financial institution portfolios. In addition, a resumption of bank lending may require a recapitalization of the banking system, which may be difficult to accomplish without large-scale government lending, or the creation of significant moral hazard problems. Moreover, in an uncertain financial environment, it may be difficult to convince even well capitalized banks to undertake additional lending, as we discovered during the period of the "Credit Crunch" in the U. S. during the early 1990s.

### Lesson 4

Given the difficulties and costs of resolving severe financial crises, a fourth lesson, perhaps obviously so, is that prevention of crises should be a focal point of financial market regulation. In the U. S. over the past few years, we have enhanced efforts in this direction. For example, we have strengthened bank capital requirements and attempted to make them risk-based. With FDICIA, we have put into place a framework that allows us to close troubled institutions before they put the deposit insurance system at risk. We have also changed the focus of supervision to match more closely the risks faced by individual institutions, and we have encouraged institutions to improve internal risk-management practices.

In addition, we have removed antiquated restrictions on permissible activities and geographic location in order to make the financial system more diversified and more competitive. We have taken steps to strengthen the large-dollar payments system to reduce the likelihood of the transmission of financial disturbances through the payments system. And finally, we have attempted to improve the transparency of financial institutions and their activities in order to increase the scope for market discipline in guiding the evolution of financial markets.

While these are all important actions, a couple of cautionary notes are in order. First, with the strong performance of the U. S. economy over the past decade, many of these new procedures have not been tested under the fire of a significant economic downturn. Second, financial markets continue to evolve rapidly, which, as I noted earlier, will require further changes in the regulatory and supervisory structure. One ongoing development of particular note is the rapid consolidation of the financial services industry – the subject of Roger Ferguson’s remarks later today. A particular concern that I have in this regard is whether consolidation will exacerbate the problem of "Too Big to Fail" to the extent that market discipline will be applied unevenly across financial institutions of different sizes.

#### Lesson 5

The fifth and final lesson that I would take from the events of recent years is that there is significant value to having a diversified system of financial intermediation. Historically, most countries have relied heavily on the banking system as the principal source of intermediation. As we know, troubles in the banking system can weaken the intermediation process, with severe macroeconomic consequences. When intermediation is more broadly based, however, with capital markets as well as banks, the resulting system may be more stable and robust in times of crisis.

A couple of examples from recent U. S. history help illustrate this point and also illustrate some of the limits to diversification. First, if we look back to the 1960s and 1970s, we see how dependent the housing market was on the health of the savings and loan industry, which, at the time, was the predominant source of funds for housing. In particular, when Regulation Q ceilings curtailed the flow of funds into savings and loans, there was an immediate impact on housing. Contrast this to the situation in the early 1990s when the economy was recovering from the 1990-1991 recession. Housing bounced back strongly even though a large part of the savings and loan industry was being closed down. By this time commercial banks and the secondary mortgage market had become important sources of housing funds and were able to continue lending despite the problems in the savings and loan industry.

A second example is the impact of the Asian financial crises in the fall of 1998. Capital markets seized up suddenly, and even prime corporate borrowers found a sharply higher cost and reduced availability of funds in capital markets. Banks continued to lend during this period, however, and were able to take up much of the slack that had developed in

capital markets. As a result, there was little reduction of credit availability and the Asian financial crisis appears to have had little impact on U. S. economic growth.

These examples suggest the presence of multiple channels of financial intermediation may make the financial system more robust to problems in particular sectors. However, even in the U. S., it is important to recognize that banks and capital markets are not perfect substitutes. While banks lend to a broad spectrum of businesses, capital markets are less open to the needs of smaller businesses. Thus, while capital markets provided some offset to the reduction of bank lending during the 1989-1992 credit crunch, the offset was not complete, and small businesses continued to have difficulty obtaining funds. As a consequence, the reduction of bank lending was probably a contributing factor to the slow recovery of the economy from the 1990-1991 recession despite the presence of alternative sources of funds for some borrowers.

### Implications for the Federal Reserve's Role in Crisis Management

I would like to close today with some observations regarding how changes in financial markets are likely to affect the Federal Reserve's role in crisis management. In doing so, I would like to return to Hy Minsky's discussion in his book *Stabilizing an Unstable Economy*. In that book, Hy attributed the relative mildness of financial crises in much of the post-war period, in part, to "prompt and effective lender-of-last-resort interventions by the Federal Reserve System, the FDIC, and cooperating private institutions." The issue that I would like to address is whether the changes in financial markets and institutions over the past twenty years have materially altered the Federal Reserve's role.

Indeed, I believe they have, in several important respects. It is noteworthy, I think, that we now talk about "financial crises" instead of "banking crises" or "banking panics," a change that is reflective of the evolution of financial markets. This change in terminology appears quite apt as financial crises increasingly appear to start outside of the banking system, in nonbank financial intermediaries, capital markets, or foreign exchange markets. Thus, the question emerges; can the Federal Reserve respond to "financial crises" in the same way that it responded to "banking crises" in the past?

My own view is that the Federal Reserve now has less flexibility in responding to crises as this relates to its operation of the discount window. Historically, the discount window has been the Federal Reserve's principal facility for providing liquidity in times of crisis. Indeed, going back to the 1980s and early 1990s, the Federal Reserve provided extensive lending through its extended credit program to banks experiencing prolonged liquidity problems. Going forward, however, the discount window is less likely to be used for several reasons.

First, use of the window is now circumscribed by the provisions of FDICIA designed to minimize FDIC exposure if the Federal Reserve lends to institutions that ultimately fail. Second, banks have become reluctant to use the window in normal times and so may not be willing to approach the window in difficult times for fear of signaling changes in their condition. Third, to the extent that crises now originate outside the banking system,

nonbank institutions do not have direct access to the discount window to meet their liquidity needs.

It should not be too surprising, then, that the Federal Reserve's response to the Asian financial crisis, like the response to the 1987 stock market crash, was to provide liquidity through open market operations by lowering the federal funds rate target rather than by using the discount window. However, using open market operations rather than the discount window has potential implications for the overall stance of monetary policy. When the Federal Reserve provided extended credit to the banking system in the 1980s and early 1990s, discount window borrowing was generally offset by open market operations to keep overall liquidity in the banking system unchanged. As a result, the stance of monetary policy was kept independent of liquidity provision via the discount window.

In contrast, when the Federal Reserve uses open market operations without the discount window, the stance of monetary policy is changed. This raises two concerns. First, what if the appropriate monetary policy stance conflicts with the need to provide liquidity to individual institutions or to financial markets? Second, if open market operations are used to provide additional liquidity in times of crisis, when is the appropriate time to remove this liquidity to prevent a buildup of inflationary pressures? These are important questions deserving further research and analysis.

#### Concluding Comments

In conclusion, I believe that the changes in the financial structure and the financial crises we have experienced in recent years have had far-reaching implications for financial market regulation and for the Federal Reserve's role in promoting economic and financial stability. At the same time, these developments serve to emphasize the continuing relevance of Hy Minsky's work for understanding the relationship between the financial system and the economy. Never has this been truer than today with our even larger institutions and our even more interdependent market systems.