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THE IMPORTANCE OF A SOUND FINANCIAL SYSTEM IN HELPING COUNTRIES OVERCOME FINANCIAL CRISIS

7 PRINCIPLES FOR POLICYMAKERS

Remarks by the Honorable Nicholas F. Brady,
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I am delighted to be here and would like to thank the Asian Development Bank, and in particular President Tadao Chino, for inviting me to address such a distinguished group.

The title of this panel is Globalization and International Capital Flows—both important topics that have attracted a lot of attention. But I would like to address just one important aspect of this subject, which is the critical importance of maintaining a sound financial system—and specifically a healthy banking system. While this may sound self-evident, I am amazed at how often we forget the vitally important role that banks play in a society—a role often taken for granted. Banks provide the lubrication that makes any economic system work.

I speak on this topic from the vantage point of having been entrusted with the oversight of the world's largest financial system at a time when it faced the most severe threats to its sustainability since the great depression of the early 1930s.

From my first day in office as Secretary of the Treasury in 1988, we confronted two simultaneous threats to the solvency of the US banking system:

The first was *the Savings & Loan Crisis*, in which nearly 1,000 U.S. savings banks faced insolvency as a result of fundamental structural imbalances between their assets and liabilities.

The second was *the Debt Crisis* in developing countries, which threatened to seriously erode the capital base of nearly all of the largest U.S. banks.

The pressure that these two crises put on bank loan portfolios was made even greater by a runaway real estate bubble and a sustained period of deficit spending by the US Government. In this environment, Board Members, Regulators, Credit Committees and Shareholders all clamped down on bank managers. As a consequence, banks were paralyzed—unable to perform their essential functions as mobilizers of savings and providers of credit. These problems were all well known to the market, which valued the equities of the largest US banks at substantial discounts to their book value.

The success that we achieved in resolving these problems and averting a broad-based banking crisis has been well chronicled. I will not bore you with a recapitulation of those stories. I would, however, like to cite three salient facts:

First—The final tab for cleaning up the S&L mess was \$150 billion. While this is certainly not a trivial amount, it didn't come close to the \$500 billion cost asserted by the business, political and media establishments.

Second—The resolution of the LDC debt crisis through what became known as 'the Brady Plan' was achieved at a negligible cost to the US Government. At the same time it restructured, for example, more than \$100 billion of foreign bank debt for Mexico, Brazil and Argentina alone. The plan broke the debt gridlock and opened the door for economic growth after the lost decade of the 1980s. In doing so it also created a new asset class: publicly traded sovereign debt—Brady Bonds, which has grown to exceed half a trillion dollars and materially helped to provide funds to developing nations.

Finally—There was a third and often-overlooked leg to our strategy, which was the curtailment of escalating spending by the US government. This was accomplished through the Budget Act of 1990 that established binding caps on the amount that Congress could spend on discretionary items.

These three changes in our system required the spilling of enormous amounts of emotional and political blood. But they provided the vital underpinning for a decade of growth and prosperity in the United States.

Economies can be fragile. Moreover, they do not run independently of the forces that shape them. Misdirected economic policies will affect a country's performance which, in turn, will adversely affect its banking system, resulting in increased default rates, devaluations, rising interest rates and asset/liability mismatches. In a vicious circle, macroeconomic problems press on the banking system, and in turn problems in the banking system further pressure the host economy.

Today's headlines are dominated by stories of the more recent cases of economic crisis, notably Argentina. But before that it was Brazil. And before that it was the Asia and the Russia crises in 1997/98. And before that it was the Mexico crisis in 1995. And throughout most of this time the Japanese economy has remained stuck in a recessionary and deflationary rut, due to a large extent to the problems affecting the Japanese banks, which to date remain mostly unresolved.

While each of these country situations is unique they share many similarities. So, here are seven principles to keep in mind when dealing with financial sector difficulties today:

Principle One—Health of the Banking System is Key.

Simply put: you can't have a healthy economy with a sick banking system. Let me illustrate this key point with two contrasting examples. The first is Argentina. Among the many sad aspects of their current crisis is how the significant progress achieved during the 1990s in building an enviable banking system was completely shattered in a matter of weeks. A different and more positive example can be found in Mexico. There the remarkable advances made in the economy since the mid-1990s are largely a result of the very direct actions taken to establish a healthy banking system.

Principle Two—The Cost of Fixing a Banking Crisis Increases Directly With the Amount of Time it Takes to Do It.

Patience may be a virtue when dealing with many of life's problems, but procrastination is never the answer in addressing systemic risks to a country's banking system. I know of no bad loan problem that became better with the passage of time. We faced formidable political criticism in resolving the S&L crisis and enormous opposition from the banks to our solution for the Debt Crisis. But, if we had not moved with dispatch to resolve these problems, the costs would have been many times higher.

Principle Three—Regulatory Measures that Undermine the Banking System Will Just Make the Crisis Worse.

It was clear that in resolving the S&L crisis we needed to address weaknesses in the management and ownership of many institutions, which would require closing many of them. And, for those that stayed solvent, we instituted tough steps to ensure that our new standards would result in a healthier financial system overall. The Argentine case, on the other hand, is another story. By adopting such measures as applying different exchange rates to the deposits and loans of commercial banks, and requiring local pension funds to invest 90% of their resources in Argentine bonds, the Government, by decree, bankrupted the banking system and confiscated a thriving private pension system that was an essential part of the local capital market.

I don't want to appear too harsh towards the Argentines; they are great people and I am sure they will come to terms with what has to be done but unfortunately the future costs of resolving these problems will be massive.

Principle Four—There is No Single Solution that Fits All Financial Sector Crises.

Different countries have successfully implemented quite different reform programs. For instance, in the U.S., the reforms and rebuilding were largely accomplished with domestic institutions, whereas in others, such as in Mexico and Russia, foreign financial institutions played very prominent roles. Success comes when the powers that be finally take the decision to act and face the problem and do something about it regardless of the political costs.

Principle Five—While There May Be No Single Recipe for Success, an Essential Ingredient is Political Courage.

It is impossible to resolve a macroeconomic or banking crisis in the face of a grossly irresponsible domestic political process. In my country, a key part of the solution to the problems that I outlined earlier was the Budget Act of 1990. This was an act of clear political courage by then President George Bush, and the resulting fiscal discipline cost him dearly in the political arena—and perhaps even lost the election of 1992. But it formed the basis for the economic prosperity of the mid- and late-1990s.

Principle Six—You Will Get No Help from Those Whose Economic Interests Caused the Problem in the First Place—None.

To the contrary, these forces have their claws tightly wrapped around the system and will fight ferociously to protect their interests. The entrenched politicians of the Argentine provincial governments are a graphic example of this process. To a lesser degree, another example is the extensive interlocked interests between Japan's political forces and its private sector.

And Finally Principle Seven—Be Bold.

It has been said that a good plan violently executed now is better than a perfect plan next week. Indeed, in addressing a complicated problem such as the LDC debt crisis of the 1980s—a huge amount of time was expended in partisan debate. And remember time is your enemy as it increases the repair bill exponentially. In the case of the LDC debt crisis we took the decision to go ahead and announce the reform plan at the annual Bretton Woods Meeting—highly visible format—despite the fact that we did not have agreement among all concerned parties within the government, particularly the US Congress. It was a risk. But it worked.

Before closing let me make a general point about the People's Republic of China (PRC), our host today. It is clear that nonperforming loans present the PRC with a problem that will have to be addressed. No one should expect the situation, which has been years in the making, to be cured overnight. But it is a big step in the right direction to change the present banking arrangement from a top-down capital allocation system to one based on sound banking criteria. This can be achieved by establishing what my good friend Gerry Corrigan has called a “credit culture” in PRC banking institutions.

The principles I have outlined relate specifically to the banking sector. In addition, it is important that policymakers spare no effort to build liquid, vibrant and growing capital markets. A strong equity market is an essential ingredient for a strong economy. Like many of you, we at Darby are in the business of mobilizing capital for investment in the emerging markets, and we are expanding our activities here in Asia. A critical consideration for us as we assess risk and opportunity will be the determination shown by national authorities to secure and to build strong banking sectors and capital markets.