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Session 1: The Global Capital Market: What's Next: Questions and Answers Moderated by Meredith Brown

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SESSION 1: QUESTIONS & ANSWERS

MODERATOR: *Meredith Brown**

MR. BROWN: Michael, one thing that occurred to me as I listened to your remarks is the problem of the many different countries that are host countries. The world is interconnected. This also relates to something that Mr. Gyohten said, which is an effort to develop within a region regulation and some sharing of information. But if the world is truly global, you need the sharing of information not just within East Asia but on a global basis. The question is whether national borders protect you against an international banking crisis anymore than the steel bulkheads of the TITANIC protected that ship from the danger that occurred in one compartment and spread quickly to the rest of the ship.

You suggest one answer, which I think is very interesting, which is not a supranational banking regulation. God knows, we'll never get the political organization to do that. If Europe can't quite get to a single currency without severe heartache, how is the world going to get to a supranational banking organization? As you suggest, maybe the best approach is to have the Group of Thirty, or the group of whatever number you like, developing its own standards. What's the best way to solve the danger of an international banking crisis? Michael, do you want to try that first, and then Mr. Gyohten?

MR. PATTERSON: Let me react to some of what you said. I think that more cooperation and information sharing among regulators while not a panacea, is certainly a very good first step. That can start on a regional basis for banks that are primarily active in that region, as Toyoo said, and then evolve globally.

I like the idea of self-regulatory initiatives, like the Group of Thirty, because, as you say, it's very difficult to imagine that all the regulators of the world would get together. But in the end, I think, it is the responsibility of regulators to do what they can, and they have to be satisfied that the prescriptions developed by the self-regulatory body are ones that they are happy with.

So it's a good effort, but in the end the world's regulators are going to have to cooperate to solve this problem — and when I say "solve this problem," I don't mean that there's any

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way that they can prevent financial debacles within individual institutions, and we should never assume that they can. But if they are working closely together, know each other, have information about institutions that do business in their countries, they can react more quickly and effectively to mitigate any crisis that does occur.

MR. GYOHTEN: If you look at the experiences of Mexico or more recently Thailand, we have to conclude that the initial, and probably the most important, cause of those crises came from their own economy. You can detect rather lax elementary fiscal policies and lack of effective supervision, which of course is shared by many of the countries. But I think the idea to put your own house in order must come first.

But in the real world you really cannot expect that everybody will behave as a very good boy, so you need a certain multiterritorial arrangement to force them to follow those good principles. In that respect I certainly support the idea of setting up some kind of multiterritorial supervisory standard and functions.

Probably the biggest obstacle in meeting that goal is that each national authority still tries to maintain its own authority and they don't want to see their authority be diluted by this supranational function. So to convince them of the need to concede and compromise on their sovereignty in that respect I think a variety of private initiatives would be very useful. I think, in that sense, the Group of Thirty's work, and also some work being carried out by the Institute for International Planners in Washington and BIS, will be very important.

Inevitably this ought to be a time-consuming, step-by-step approach.

MR. BROWN: Thank you, Mr. Gyohten.

MR. VOLCKER: Let me just make a couple of comments, Meredith. In the interest of full disclosure, I'm the Chairman of the Group of Thirty, and I don't think we're going to end up running the world.

But this is a very interesting question. It's certainly right, we're not going to prevent any possibility of a financial crisis. What can we do to minimize it? Let me suggest a few, maybe rather arbitrary-sounding rules, but I think you've got to be arbitrary in some of these areas.

You can get some basic protection, I think, by assuring that no institution or set of institutions is overly large compared to the whole. I don't think we're in any immediate danger of that, and as the world gets more homogenized and institutions are acting all over, of course you have more competition and you don't have to worry so much about local, or even national, concentration. But I think ultimately you want a lot of players so you're not too dependent upon any one player. That is an arbitrary restriction, I suppose, at some point. Nonetheless, I think you get into those kinds of arbitrary restrictions.

One that we have, which goes up and down in popularity in the way it's applied, is capital requirements. It is a striking initiative that has been made in commercial banking only for a relatively uniform approach toward capital requirements right around the world for major banks. Any bank can say, "In my particular situation it's arbitrary and unreasonable because I'm different, I'm not like everybody else, and I've got better management or I've got safer assets."

But if you're going to have an effective supervisory regulatory mechanism around the world, given the pressures that have been described here, I think some uniformity in this area at the expense of arbitrariness is probably essential.

Of course, the problem now is you have that to a considerable degree in the banking world. You don't have it with all these other institutions that compete directly with banks, particularly investment banks that may be doing the same kind of business very largely, and that is one of the challenges for the future.

I can't refrain from announcing my own hobby horse in this area, one of the few things that gets me down to Washington to testify, and it refers partly to the matter of size. But I think we really ought to stop, at least for the indefinite future, financial conglomerations. The argument for that is very powerful, as Michael has described. The argument for going beyond that and linking up financial institutions with commercial establishments and industrial firms strikes me as extremely weak, and there is nothing to be gained and a whole lot to be lost in terms of the possibility of financial crisis, among other things.

MR. BROWN: Do you do that by regulation or do you do that by sort of the common sense that they don't fit together very well and eventually they get divorced — Xerox and its insurance operations, as an example?

MR. VOLCKER: I would do it by appropriate legislation, but I also think that it runs with the grain of the market for the reason that you suggest. But there are active experimenters in the other direction, which I would just as soon not — the problem is, if you let some do it, then the pressures become "why don't we weaken the law and let everybody do it?" and we'll get in trouble. I don't know whether I want to carry on that debate.

Just let me make one final point, which I think has already been raised. I do think it's important that central banks have a strong role in this, for the reasons that have already been suggested. They are the ones that have the most interest — they're the ones that are going to be blamed, for one reason, which gives them an active interest — but they're also the ones that have the resources, the prestige by and large, the knowledge, the continuity, and I think it is a mistake to remove them from the regulatory process because they're the ones that have to pick up the pieces when it inevitably happens.

I think a lot of changes made in the U.K., in terms of a central bank and some other changes, are desirable. This one I think they made a mistake on.

MR. PATTERSON: Can I make one comment, Paul? You mentioned capital requirements, and I think that is a fairly important topic. I think that you have made the point that defective capital requirements are better than none at all, but they certainly are a problem, aside from the fact that they are not uniformly required for all financial players, as you pointed out.

Just to give you one example, we have to hold eight percent capital against a one-year commitment for AAA Exxon and none at all on a thirty-year obligation for the United States to Mexico. Something is wrong there and needs to be fixed.

That example highlights one of the factors that is driving the development of the secondary market for loans that I referred to earlier. Banks can no longer afford to hold many of them on their balance sheets because the capital requirements are completely uneconomical.

MR. VOLCKER: That is one of the arbitrary elements, there is no doubt about it. You see strange results. How you deal with it in the political world is a question.

MR. BROWN: We have a comment from Mr. Gyohten, if we may.

MR. GYOHTEN: May I comment on that issue of financial conglomeration? I certainly agree with what Paul said because I believe the financial services industry is certainly different from other types of industries, in the sense that they deal with credit.

As I mentioned in my presentation, in Japan we are now contemplating the establishment of a holding company system, which was not allowed so far. In that exercise, I think we should be careful not to mix the financial services industry with other commercial-type industry too easily. So even if we are going to allow setting up of the holding company structure, I personally believe we should confine it to a financial holding company. In other words, in this group of holding company structure, only the financial service industry will be included, because if you mix ordinary industries with the credit-providing institutions, I think you cannot avoid the risk of those credit-providing institutions being influenced by different interests. So I think on this particular point we need to move cautiously.

MR. VOLCKER: If I may just make one other point, I think what lies behind a lot of this — and which was alluded to earlier one way or another earlier, but let me just make it more explicit — is this tension that exists between a perceived need of a government or a central bank to protect the stability of a system and the undue conflict that may give to participants in the system toward risk-taking, the so-called "moral hazard" — that the more assurance you give that there will be no crisis or you'll be protected from a crisis if it happens, encourages activity that will give rise to the crisis. We spend endless amounts of time worrying about that, and there is no good resolution that I know of.

But I take in this area a very old-fashioned view — maybe it's inadequate — that I hate to expand the presumption of protection beyond something called a commercial bank. I would say "something called a commercial bank" because the boundaries of commercial banking get a little fuzzy. But I would just as soon avoid any presumption, if I can, of government support for people that participate in certain defined activities. Operation of a payment system, providers of liquidity, creators of money are all fuzzy concepts, but nonetheless I think somewhat definable. Simply to try to minimize the so-called moral hazard — and it is one element in this extension of financial institutions that include banks beyond finance, because then it implies — and Michael made a very eloquent statement about how a bank or any organization wants to operate its organization as a comprehensive whole, without all these intrusive, so-called "firewalls" and restrictions, and have one capital pool that can be allocated.

If that's all true, and it's true if you run a commercial operation too, you are extending the so-called federal safety net, if you have it, beyond the bank, beyond the financial world, into the commercial world. That implies a degree of regulation. I don't think we want capital requirements on General Motors.

MR. BROWN: And when does a bank end and GE begin, for example?

MR. VOLCKER: That is correct. You've got to make a distinction.

MR. BROWN: I think we have raised a large number of questions. There is one sort of helpful benediction that I can give you from the Managing Director of the IMF, who said, I don't know where we'll have or when we'll have the next international economic crisis, but I suspect it will begin with a banking crisis.