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# In a world of open capital markets, how can central banks best help banking systems remain strong?

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## Introduction

I appreciate your invitation to address you this morning and I join with others in welcoming you all to New Zealand. This country can not be regarded as truly Asian, but we are increasingly integrated into the Asian region, through trade, through immigration, through political and diplomatic linkages, through cultural exchanges, and, in my own case, through marriage!

Whereas when I went through school almost the only foreign language learnt in New Zealand schools was French, now more New Zealand students learn Japanese than learn any other foreign language, with many students also studying Mandarin and Indonesian.

Whereas when I went through school the United Kingdom took roughly half of New Zealand's exports, now the British market takes only some 7 percent of our exports, with Japan taking 16 percent, China/Hong Kong taking 6 percent, and Korea (in 1997) taking 5 percent. Seven of our largest 10 export markets are now in this region.

Whereas when I went through school almost all immigrants to New Zealand came from the United Kingdom, Australia or the Pacific Islands, in the last few years a great many immigrants have come from East Asia – especially from China/Hong Kong, Taiwan, and Korea. And New Zealand has gained enormously from these immigrants, who have tended to be hard-working, thrifty, enthusiastic about education, and enterprising. They have enriched our culture and helped our economy.

Whereas when I went to school New Zealanders seeking international experience inevitably travelled to the United Kingdom and Europe, typically by means of a ship which travelled via the Panama Canal and lots and lots of ocean,

today many New Zealanders seek overseas experience in the countries of Asia and, even when travelling to Europe, travel via several Asian countries.

This year and next, the Reserve Bank of New Zealand holds the Chair of SEANZA, a grouping of 20 central banks in the Asian region originally formed in the mid-fifties, and we were a founding member of EMEAP, an 11-country group of East Asian central banks. (Indeed, we hosted two of the three EMEAP working groups in New Zealand last month.) And, of course, next year New Zealand will host the APEC Leaders' meeting here in Auckland.

So we are increasingly a part of the Asian region, and have a vital stake in the prosperity of the region.

And in that regard, everybody in this room, and indeed almost everybody in this country, is very much aware of the stresses and strains which several of the countries in the region have been going through in the last few months. Even countries which have not experienced severe turbulence in their currency markets in some cases face very considerable pressures on their banking systems, so that it is no exaggeration to say that *most* of the people in the region live in countries where banking systems are under real strain.

Oceans of ink have been spilt in analysing the causes of these strains, and this analysis will no doubt continue for a long time to come. Most detached observers seem to agree that the underlying problems had nothing to do with the real or imagined activities of foreign speculators but a great deal to do with more fundamental factors, factors which clearly varied from country to country, but which included politically-directed lending by banks, the end of a real estate bubble, sharply increased real

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exchange rates in a pegged exchange rate situation, a lack of transparency in financial markets, and, dare I say it to this audience, some poor quality credit analysis by some of the banks and other financial institutions.

I do not propose to offer my own analysis of the causes of ‘the Asian crisis’ this morning. I was originally invited to speak about ‘the role of central banks, the New Zealand experience’. But instead I want to tailor my remarks more specifically to the theme of your conference, “Open Markets – the implication for Banks in the Asian Pacific Region”. So for this reason I want to focus this morning on a question, namely “In a world of open capital markets, how can central banks best help banking systems remain strong?” Not surprisingly, my remarks will be heavily conditioned by our own experience in New Zealand.

While we are all conscious of the strains currently besetting the banking systems in many Asian countries, not all of you will be aware that we in New Zealand had our own banking system problems less than 10 years ago. As a result of these problems, our largest bank would almost certainly have failed had the government, as majority shareholder, not been willing on two occasions to provide a substantial capital injection. One very major financial institution (not a bank, but certainly a quasi-bank, and an institution which was in the process of applying for a banking licence) did fail, one of the largest failures in New Zealand’s history. Another bank would have failed had its private sector shareholder not been in a position to inject very large amounts of additional capital, and even after that was done the institution was eventually wound up. At no point did it look likely that the whole banking system might fail, but we certainly had major problems with some of the largest participants in the system.

What lessons did we learn from that experience? There were, of course, a whole host of factors which caused these difficulties. One important factor was the sheer inexperience of many of our bankers: they had been accus-

tomed to a highly *protected* environment, and were ill-prepared to deal with the demands of a *deregulated* environment. Nevertheless, I think there were four important lessons. While every country has to make judgements and decisions in the light of its own particular circumstances – and certainly no two countries are exactly alike – some of the things we learnt may have relevance to other countries also.

### **Lessons from New Zealand: encourage banks to behave prudently**

First, it is important that banks are given every incentive to behave prudently. This may seem a self-evident statement, but it is astonishing how frequently the importance of this principle is ignored. In New Zealand’s case, we diminished this incentive to behave prudently by allowing the view to go unchallenged that banks were effectively ‘sovereign risk’, or at least ‘too big to fail’. This meant that bank creditors felt little need to assess the creditworthiness of the banks with which they deposited funds – banks were, it was widely believed, effectively guaranteed by government. Bank boards and managements may have felt similarly protected against the possibility of failure, and made loans with a disregard for risk which was, in some cases, breath-taking. This so-called ‘moral hazard problem’ may have been particularly severe in the case of two of the three institutions which got into serious difficulties in the late eighties, both of them owned wholly or in part by government. There was little or no direction of their lending by government, but the management of both institutions certainly embarked upon lending transactions in the newly liberalised environment which rapidly got them into serious difficulties.

In some Asian countries, it is possible that the incentive for banks to behave prudently was seriously eroded not only by the impression that most large financial institutions would not be allowed to fail but also by the extent to which governments directed the lending activities of the banks themselves. After all, if governments

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are going to become extensively involved in directing where banks should and should not lend, it is not unreasonable if the banks and their creditors assume that governments will 'see them right' if things go wrong. Bank management certainly has little incentive to carefully assess credit risk if, at the end of the day, the decision on whether or not to lend will be made by the bank's board under the influence or direction of higher political authority.

At the moment, there is a great deal of international attention focused on how this problem of poor credit decisions in the banking sector can be dealt with. Most of the attention is on how official banking supervision and banking regulation can be improved, and made more independent of political influence. Certainly, freeing banks from political interference in their credit decisions is very desirable, and better banking supervision is one possible way to reduce the risks of future problems in the banking system.

But, as some of you perhaps know, we in New Zealand are not persuaded that improving the quality of official banking supervision is the only way to proceed, or indeed even necessarily the best way to proceed in all circumstances. When we reviewed what we were doing in banking supervision in the early nineties, we became concerned. At that time, we were conducting banking supervision along conventional Basle Committee lines. We were gathering very large amounts of confidential information from banks on a quarterly (sometimes a monthly) basis. We were laying down a large number of rules and limits designed to ensure that banks behaved prudently.

Several things prompted us to review that approach, and one of them was a worry about the risks which we were incurring on behalf of taxpayers. What would happen if, despite our banking supervision, a bank were to get into difficulties? Might depositors argue that they wanted full compensation, since while *they* had had no knowledge of the bank's financial condition *we* in the Reserve Bank were not only fully aware of that condition but were also re-

sponsible for laying down the rules and limits by which the bank had been obliged to operate?

We consoled ourselves with the thought that our banking supervision was so good that no banks would fail under our watchful eye. But then we looked abroad – at the United States, at Japan, at Scandinavia, at the United Kingdom, at Australia, and indeed even at New Zealand itself. We found banks going down in significant numbers, despite some extremely professional and politically-independent banking supervision. We could *not* be confident that traditional banking supervision would prevent bank failure, and we *could* be confident that, by being the sole recipient of detailed financial information on banks and the main arbiter of what constituted prudent banking behaviour, there was a major risk that we would be held liable, politically and morally if not legally, for any losses incurred by depositors.

Then we became aware of anecdotal evidence that our banking supervision was reducing the incentive for bank directors to make their own decisions about crucial aspects of their bank's operations. In other words, because the Reserve Bank was laying down maximum individual credit limits, and limits on open foreign exchange positions, and guidelines for internal controls, some bank directors were assuming that they were necessarily behaving prudently provided they were operating within those limits and guidelines. They stopped addressing the risks which their own banks were facing and simply complied with the general limits and guidelines. To the extent that that was true – and, as I say, we found some evidence that it was true in some banks – we concluded that our banking supervision might actually be *increasing* the risk of bank failure, by reducing the incentive for bank directors and bank managers to make their own careful assessment of risk.

So we retain a system of official banking supervision, and we take it very seriously. But we retain only a few absolute rules within that framework, principally that all banks must at

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least meet the Basle capital adequacy rules, and rely mainly on a requirement that banks disclose to the *public* a substantial amount of financial information quarterly. In addition, all bank directors must sign off these quarterly statements, at the same time attesting to the fact that the internal controls of their banks are appropriate to the nature of their banking business, and that those controls are being properly applied. We in the Reserve Bank do not attempt to tell banks what those controls should look like, but directors signing those quarterly statements without making a careful assessment of the adequacy of internal controls are exposing themselves to very considerable legal risk in the event that their bank gets into difficulty.

We have also gone out of our way on a number of occasions to make it clear to the public that neither the Reserve Bank nor the government of New Zealand is guaranteeing individual banks, and we published a booklet designed to assist the general public to interpret banks' financial information.

None of these actions is a guarantee against imprudent bank behaviour, but we believe that we have gone a considerable distance towards ensuring that banks face strong incentives to behave prudently. No bank operating in New Zealand is now owned by government, none is guaranteed by government, none is obliged to lend to particular sectors or companies, and our supervision is based heavily on mandatory public disclosure and director attestations. As Alan Greenspan said last year, "Regulation by government unavoidably involves some element of perverse incentives. If private market participants believe that government is protecting their interests, their own efforts to do so will diminish."<sup>1</sup> We have tried to minimise those perverse incentives.

Of course, to some extent this approach only works where there is a clear framework of company law which makes it clear that company

directors and managers have unambiguous responsibilities. Having agreed accounting rules is important. Having a vigorous media, with probing financial journalists, is also of great value, so that when a bank is forced to disclose to the public a deteriorating financial position, or a breach of one of the few rules we retain, there is at least a reasonable chance of that being picked up and sensibly analysed by the media. Not all countries are so lucky.

So far at least, we are well satisfied by the way in which the new system is working. (A few months after the new system first came into operation, at the beginning of 1996, one bank was obliged to disclose the fact that it had had a credit exposure to its shareholder bank which considerably exceeded the limit which we had stipulated for such exposure. The attention focused on this issue by the media, and indeed by other banks, created strong incentives for the bank never to repeat that mistake – quite probably stronger incentives than any threat of central bank sanction could have created.)

### **Lessons from New Zealand: beware of government ownership of banks**

The second lesson from the New Zealand experience in the late eighties is that the ownership of banks is an important issue. For us, the issue was in part government ownership of banks and in part foreign ownership of banks. The government-owned financial institutions, almost without exception, suffered various degrees of financial difficulty – sometimes because their managers had undertaken imprudent lending, and sometimes because they had been obliged to invest in large amounts of government securities at sub-market interest rates. The large foreign-owned banks suffered to a much more limited extent from the bad debts and losses which the government-owned banks experienced.

There have been various reasons given for this difference, but the most plausible is that the large foreign-owned banks were under the

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<sup>1</sup> Remarks by the Chairman of the Board of the US Federal Reserve System, Dr Alan Greenspan, at the annual conference of the Association of Private Enterprise Education, in Arlington, Virginia, on 12 April 1997.

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watchful eye of experienced parent banks, and were therefore much less able to stray into some of the riskier propositions which tempted the government-owned institutions, especially in the years immediately after the banking sector was liberalised in the mid-eighties. (The newly-arrived foreign-owned banks, however, often did succumb to the temptation of lending on risky propositions, perhaps because, being quite small both in absolute terms and in relation to their overseas parents, they were subject to much less intensive parental scrutiny.)

More recently, New Zealand has been running a very large balance of payments deficit, probably amounting to more than 7 percent of GDP at the present time. As in some Asian countries, this balance of payments deficit has been experienced at a time when the government itself is running a fiscal surplus. In other words, it has been the private sector which has been borrowing heavily from overseas, not the public sector. And while some of this borrowing has been done by the corporate sector directly, much of it has been done by the banking sector. Comparable levels of overseas borrowing by some Asian banks have been sufficient to make foreign lenders very nervous, and yet similar nervousness has not been at all evident in New Zealand. Why? I can only conclude that the foreign lenders take considerable comfort from the fact that most of the banks operating in New Zealand now are in fact wholly-owned by foreign banks, or are indeed branches of foreign banks. Those parents are seen as being financially strong, and fully able to back the operations of their New Zealand subsidiaries or branches. (It may also be relevant that, overwhelmingly, the overseas borrowing being undertaken by New Zealand banks carries no foreign exchange risk for the banks themselves.)

In some countries, there is political reluctance to allow foreign institutions unrestricted entry into local banking sectors. I would have to say that, as a country where all but one of our 19 banks are owned and controlled overseas, we have seen absolutely no disadvantages from this situation, and many advantages. We have a fi-

nancially stable banking sector, with vigorously competing and highly innovative banks, all of them subject to the monetary policy influence of the central bank. I have no doubt at all that the banking sector is considerably more stable than would have been the case had all the banks been domestically-owned, whether in the private sector or in the public sector.

### **Lessons from New Zealand: keep prices stable**

The third lesson from our experience has been the crucial importance of keeping prices stable. By the late eighties, New Zealand had experienced nearly 20 years during which inflation had been above 10 percent almost without a break. Interest rates after adjustment for tax and inflation were often strongly negative, and there was as a consequence a strong incentive to invest in real estate and shares, using as much borrowed money as could be obtained. This was undoubtedly an important contributor to the severe difficulties which both the corporate sector and some parts of the banking sector experienced when monetary policy was tightened in order to reduce inflation. Interest rates went up and asset prices went down, and several banks incurred very large losses as a consequence.

Asian countries have an enviable record of combining very rapid rates of economic growth with rates of inflation which, by the standards of many other countries, have been low or moderate. But it is also true that in many Asian countries relatively low *consumer* price inflation has been accompanied by a huge escalation in *asset* prices. There is no single explanation for this phenomenon and, as New Zealand has itself discovered over recent years with quite a strong increase in the price of both residential and rural property, it is often extraordinarily difficult to restrain asset price inflation even when inflation in consumer prices is low.

But it is at least possible that asset price inflation in Japan in the late eighties – the reversal of which has done so much damage to bank

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balance sheets in that country – was a consequence of monetary policy being kept too easy for too long, whether to appease the United States after the Plaza Accord or for some other reason I know not. Similarly, it may well be that if central banks in some other Asian countries had not been so preoccupied with trying to avoid the appreciation of their currencies against the US dollar as capital flowed into these economies in recent years, their interest rates would have been higher and asset price inflation commensurately reduced. And, of course, if asset price inflation had been less, the over-investment in certain kinds of real estate would presumably have been less and, with that, the subsequent fall in asset prices would have been less also.

### **Lessons from New Zealand: avoid pegging the exchange rate**

And that brings me on rather naturally to the final lesson from New Zealand experience, and that is the danger of pegging the exchange rate unless you are prepared to go all the way to a currency board, as Hong Kong has done, and have the political and banking sector strength to endure the economic, political, and social pain which is inevitably associated with a currency board arrangement from time to time.

In New Zealand, we had a pegged exchange rate until March 1985. Prior to that date, it was not uncommon for companies to borrow overseas, often at interest rates which were very much lower than those within the high inflation New Zealand economy. Some companies made rather spectacular losses when the New Zealand dollar was devalued from time to time, or when, even when pegged, the New Zealand dollar depreciated against the currency in which the loan was denominated. (Borrowing in Swiss francs was particularly popular, and particularly painful, for some companies.) But the losses were probably fairly moderate in comparison to the loss which the government itself incurred on behalf of taxpayers in 1984. In that year, the New Zealand dollar was devalued by 20 percent after a foreign exchange crisis which had certain similarities to some of those in Asia

more recently, and the government, which had written very large volumes of forward exchange contracts with companies trying to protect their positions, incurred losses of many hundreds of millions of dollars.

Since March 1985, the New Zealand dollar has been freely floating, and indeed I suspect we may be the only central bank that can claim not to have intervened directly in the foreign exchange market for more than 13 years. (I say ‘directly’ because from time to time we did adjust monetary policy when we felt that movements in the exchange rate seemed likely to threaten our single goal of low inflation.) One of the benefits of this has been that, though many companies and banks have borrowed overseas, none of this borrowing was undertaken in the belief that there was no currency risk involved. Overseas interest rates were frequently much lower than those in New Zealand but, after factoring in the exchange rate risk, the incentive to borrow offshore in foreign currency was substantially reduced.

As a consequence, when, after a period of strong New Zealand dollar appreciation between early 1993 and early 1997, the New Zealand dollar fell by some 18 percent against the US dollar, there were very few companies unhappy about that fall – and indeed plenty of exporters who were delighted. Even fewer of our banks were caught out by the depreciation, and, to the best of my knowledge, none incurred losses as a consequence of the move. Because they *knew* that the New Zealand dollar was freely floating, they were careful to avoid taking on unhedged positions in foreign currency.

### **Conclusion**

In conclusion, in a world of open capital markets, the challenges facing banks are very considerable. Central banks cannot prevent all banks from getting into trouble, and nor should they try to do so. But central banks do have a responsibility in all our countries to promote the stability of the banking sector. In my own view, they can best do that by creating strong incentives for banks to behave prudently; by

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discouraging government ownership of banks, and removing barriers to the foreign ownership of banks; by keeping the focus of monetary policy on price stability; and by not creating the impression that borrowing in foreign currency is a riskless activity. We learnt those lessons the hard way.