

A strategy for promoting financial stability

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1. What do we mean by financial instability?

- Short-term market volatility.
- Medium-term credit excess and price misalignments.
- Financial contagion across markets and countries.

2. Why is financial instability costly?

- Short-term market volatility and market failure (Russia and LTCM).
- Medium-term credit excesses and asset price misalignment (Japan).
- Joint exchange rate and banking crises (Mexico and South-East Asia); the currency mismatch problem.

3. Particular factors contributing to financial instability in emerging markets

- Starting point problems and weak governance.
- Problems associated with financial deregulation and increased competition.
- Underdeveloped and illiquid financial markets.
- Underdeveloped financial infrastructure.

4. Promoting financial stability: three basic principles

- Financial market liberalisation driven irreversibly by technological developments.
- As domestic markets open to international influences, international standards of best practice should prevail.
- Measures to prevent crises, manage crises and resolve crises differ and sometimes conflict (moral hazard).

5. Crisis prevention

- A four-dimensional systemic risk matrix.
- Microprudential policies to strengthen financial infrastructure, financial institutions and market functioning.
- A macroprudential approach using monetary and regulatory policies.

6. Crisis management

- The role of the domestic private sector.
- The role of the domestic public sector.
- International liquidity support and external debt restructuring.

7. Crisis resolution

- The role of the private sector.
- The role of the domestic public sector.
- External debt reduction.

8. Implementation of suggested measures

- Impediments to doing the right thing.
- Incentives for doing the right thing.