In Praise of Financial Plumbers

Want a formula for achieving developing economy success? Begin with sound, independent supervisors.

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During the past thirty years, the developing nations around the globe have been buffeted by a series of economic and financial crises. Inevitably, this has resulted in substantially increased unemployment, stagnant growth, lowered living standards, attacks on globalization, and eventually challenges to the institution of democracy. Hungry people do not much appreciate the benefits of globalization simply because few, if any, of these benefits have come their way. As they see it, globalization benefits the rich nations and the rich elites but not them.

Economic problems can rise from a number of causes over which an individual developing nation has little influence. Countries whose economies are based upon natural resources—oil, copper, coffee—cannot control the pricing of these commodities in global markets. Prices are demand-driven, not supply-driven. Nevertheless, regardless of commodity pricing, countries can control their own domestic finances, the prudent handling of which will diminish the negative impact of global market turbulence.

The correct balance of fiscal and monetary policies is within national governments' reach. Spending and tax policies, on the one hand, and a monetary policy that stimulates growth without fueling inflation are key. The International Monetary Fund requires the proper balance when imposing conditionality on countries seeking financial assistance.

Countries that need the financial support of the IMF accept these programs as the cost of getting the money. But many other nations do not balance fiscal and monetary policy since there is no meaningful enforcement mechanism. These sovereign nations create their own destiny, that is until they get into trouble and apply to the IMF. And once a country has a flawed macro-economic policy, the inevitable economic disaster is exacerbated by a weak financial system.

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We have learned by experience that when a nation has poor macro-economic underpinnings and a weak financial system, there is bound to be a disaster that will have dramatic, if not devastating, effects. Similarly, when a nation has a reasonably good balance of macroeconomic policies but still hosts a weak financial system, the inevitable result is the same. But if there is a financial system that is relatively robust, even in a relatively poor macroeconomic setting, the results are far more benign. There are problems, of course, but they are not nearly as severe as when the financial system is weak which, by definition, means poorly supervised.

Since the financial markets of the world are inextricably interlinked, the problems in one country quickly are exported to others. Problems of a domestic nature often ripple out to weaken or destroy other economies far from the initial trouble. Such was the case with the Latin American crisis in the 1980s, the problems arising in South East Asia in 1997, and Mexico's peso crisis in 1994–1995.

If we simply recognize the reality that sovereign nations will do what they will and in that process continue to create periodic economic crises, then it just makes common sense to strengthen that set of activities which will minimize the damage done by short-sighted politicians.

If we are to improve the ability of developing countries to withstand inevitable swings, instead of just relying solely upon spouting the macro-economic gospel, it would be prudent to strengthen the financial systems and financial institutions within those nations. This requires supervision with teeth and people who are capable of bringing this to pass.

More must be done to educate and train supervisors to do their job well, especially in developing and transitional economies in which these activities are often given short shrift in terms of funding and support. Add to this picture the differences between education and training in one country and the next, and the result is little supervisory consistency across borders and a mixed application across the globe.

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Despite the growing need for supervisory prowess, getting countries to focus on the importance of allotting sufficient resources to the task is tough. Perhaps the issue is too arcane to capture the attention it deserves. Perhaps people just assume that since the need is so clear, that the job has been done.

It doesn't help that some doubt that increased supervisory systems are a priority in the first place. These naysayers believe that financial institutions can police themselves. Sadly, experience shows that unless pushed, most financial institutions won't take the steps necessary to strengthen themselves and/or the system as a whole.

Moreover, supervisors can't toot their own horns to gather public support because simply mentioning a success might cause a bank run. After all, who wants his money in a bank with a whiff of danger? Instead, the very nature of the job shines the spotlight on supervisors only when things go wrong.

The financial supervisor really is the foot soldier of financial stability while macroeconomic policies are like carpet bombing. They are done from 60,000 feet.

Creating vibrant supervision also may take more effort and dedication than most countries are willing or able to spare. Not only do education and training demand a lot of money and hard work, but also the crucial setting up of independent agencies can be too politically charged to accomplish easily.

INDEPENDENCE IS KEY

Supervisors do not operate in a vacuum. Especially in countries ruled by a small power elite, a supervisor confronts enormous political pressures in trying to do his job right. Without independence, he will be constantly subject to the burdens of political whim *du jour.*

The importance of operating at a remove from political interference is clear. For instance, if you are the supervisor and the president can fire you, it may dampen your enthusiasm to close a seriously troubled bank that is owned by a member of the family or his biggest contributor. By contrast, if the president can't fire you, and you are so inclined, you will be able to do your job. Setting a term not coincident with the election cycle of the president removes his ability to fire the supervisor or—as is more often the case in practice—decide not to renew his appointment.

Similarly, independence can be fettered by heavy-handed pressure from a country's legislative body, which in many countries ratifies the supervisor's appointment. Using fees from regulated institutions, rather than taxpayer funds, can protect the supervisory agency from being crippled in the appropriations process without jeopardizing the ultimate accountability of the supervisor to the legislative body.

Organizational structure can also further supervisory independence. The best option is to have a stand-alone agency that is not part of the central bank and that does not report to the ministry of finance. Lacking sufficient resources, talent, or political will, the next best solution is to be under the aegis of an independent central bank. The worst tack, by far, is to have the supervisor report to the treasury or ministry of finance because that is political by definition. The minister of finance will act for political gain even if it results in weak financial supervision that, in turn, leads to a whole host of future problems.

Japan is the perfect example of how to do it incorrectly. There, the banking supervisory agency for years reported to the Ministry of Finance although it recently became independent. The cultural system and political pressures did not permit weak and failing banks to close, which has mired Japan in a decade-long economic slowdown.

Independence can be tough to define and thus to actuate as it can mean many different things to different people. For example, when the Basel Committee on Banking Supervision published its core principles in 1988, principle number one was independent banking supervision. Basically, 85 percent of the countries in the world signed on to that. The question then became what did they understand as being independent since many financial supervisors remain subject to political meddling.

EDUCATION AND TRAINING HELPS

This makes education and training crucial tools for change. The need for independence can be stressed by showing the benefits of having it and the horrors of not having it. Cadres of people within a country can emerge who know what they should be doing and what should be done.

You cannot take someone off the street and transform him into a financial supervisor overnight by giving him a textbook. Indeed, in the United States, it takes about five years to train a college graduate to become a first-rate bank examiner. A supervisor's role is just too subtle both in terms of setting standards and enforcing them. He must exercise subjective judgments based on concepts and experience, not just on enforcing rules. Achieving compliance by overseen institutions takes a mix of patience, ingenuity, diplomacy, moral suasion, and political savvy.

When the supervisor is doing his or her job correctly, the right policies and procedures for capital adequacy and prudent banking practices are in place so that the board and managers of a financial institution can do a good job. After all, the supervisor's purview is not to run the institution himself, but to set parameters and offer guidance when problems occur. Supervisors also must work behind the scenes to shore up weak institutions.

Since most banks are owned by shareholders, a supervisor first acts to convince a board of directors to change management or to take other steps to recovery. If a bank is unsalvageable, it must be closed with the least economic disruption possible. In 1989, regulators took over a year to shutter the Bank of New England. In the meantime, they overhauled management who sold healthy divisions at non-fire-sale prices. They gave everyone the chance to get used to reality: those with uninsured deposits over $100,000 could reduce them; creditors had a chance to be repaid; borrowers had time to find new lenders. Because of the supervisor's skillful work, when the actual closing finally occurred, it was an anti-climax.

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Since that time, the need to train strong supervisors has been gaining momentum. The most recent guidelines from the Basel Committee on Banking Supervision—so-called Basel II—up the ante for well-trained, knowledgeable and experienced supervisors by calling for "supervisory review." This means supervisors must use more judgment, instead of relying solely on the quantifiable measures of the past such as a tally of bad loans.

Indeed, the resolution of the failure of the Bank of New England and of other crises would not have gone as smoothly if supervisors had not been enabled and encouraged to use their judgment rather than just impose hard-and-fast rules. Following the letter of the law can create new problems that a more subtle approach can avoid.

CONCLUSION

Market pressure should reinforce the message that strong supervision is key. After all, countries with financial institutions that are perceived as weak will have to pay more to borrow money. Extra pressure could be exerted by using benchmarks to measure the level of supervision in one country versus another. Whether by independent groups, rating agencies, or even magazines, public rankings could serve as lending guidelines. Not only would finance ministers pay more attention to the need for supervision, but also foreign banks would be more careful, since lending to a poorly rated country that later got into trouble could set it up for losses and a stockholder suit.

In the end, the financial supervisor really is the foot soldier of financial stability while macroeconomic policies are like carpet bombing. They are done from 60,000 feet. They are very broad. They are sweeping. Or, to put it a different way, financial supervisors are the plumbers and macro economists the architects. They can build a beautiful house, but if the plumbing doesn't work, no one will want to live there. Similarly, if you really want to help countries build a strong foundation for growth, you need to have strong, well-managed financial systems with experienced, well-trained, and independent supervisors. ◆