Speech

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A Central Banker's view on the rapid financial developments

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I am grateful to the OM-group for providing me this opportunity to visit Bürgenstock and address The International Forum for Derivative Markets.

As a result of changes in communications and information technology, and the new instruments and risk management techniques they have made possible, the financial system is far more efficient today than ever before. The financial developments and their internationalisation are basically a natural feature of a market economy, a logical consequence of an ongoing, rapid economic evolution which creates a need of new financial solutions among firms and households. What we don't yet know for sure, but strongly suspect, is that the present accelerating expansion of global finance may be indispensable to the continued rapid growth in world trade in goods and services.

However, for a central banker with responsibilities for financial stability, the rapid development and transformation have presented new challenges.

The new instruments and techniques have strengthened interdependencies between markets and market participants, both within and across national boundaries. As a result, a disturbance in one market segment or in one country is likely to be transmitted rapidly throughout the world economy. We also know from history that adjustment processes within economies have – from time to time – created difficulties to varying degrees. Accordingly, we have seen financial crises developing in several countries, including my own, during recent years.

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Today I should like to discuss the development in the financial sector and to say a few words about the challenges facing a central banker.

A financial revolution

The financial system has not been developed for its own sake. Neither is it a new creation. Its purpose is to facilitate production and trade in goods and services. People have engaged in financial transactions since the dawn of recorded history.

Historians tell us that already in Mesopotamia around 3000 BC there was a systematic use of credit for agricultural and other purposes. Banking institutions arose in the state of Genua in the twelfth century, and flourished there and in Florence and Venice for several centuries. Issuance of securities similar to the modern form also originated in the Italian city-states in the late Middle Ages. Even organised exchanges for trading financial futures contracts and other financial derivatives are not entirely new. Similar contracts were widely traded on the Amsterdam securities exchange in the 1600s.

As a little bit of history makes clear, some things have not changed. Financial activities, such as borrowing, investing in securities and other forms of financial contracting, are very old indeed. The ways in which these activities are carried out, however, have changed through the ages.

Since the mid 1980s the pace of financial innovations has greatly accelerated. It is probably no exaggeration to say that the past decade has seen the beginning of a revolutionary process of change and transformation, with consequences that are still only partly discernible.

Deregulation, globalisation, advances in information technology and new methods for risk evaluation and management have all helped to initiate a dynamic process in which financial markets, institutions and instruments interact. There are clear parallels with past century's real economic growth, where a continuous influx of more efficient and specialised production processes and new facilities for communication led to lower costs and an expanding volume of trade.

The changing financial scene is a result of, but is also initiating, transformation and new behaviour in the private sector. The role of banks will certainly change further in the future as they are being affected by trends which already have become discernible.

Banking is traditionally about the management of funds deposited by the non-bank public. Deposits, usually payable on demand, are converted by the banks into longer term loans to businesses and individuals. Banks are thus involved in maturity transformation - a very important function for the general economy. Banks also have long-standing relationships with their customers, leading to an information advantage. They may therefore feel safe to extend loans where other venues, such as bond markets, are closed.

However, this role for banks is now increasingly challenged. Competition for savings is growing and, on the lending side, new forms of credit arrangements are being developed. The information advantage is being squeezed by improved transparency in the markets.

Obviously, traditional banking is hard pressed from many quarters and the banks are trying to adapt in order to survive. Most likely we will se continuing changes in the banking systems, structural and otherwise, over the next five to ten years.

As regards *savings*, an important factor is demographic. In the Western world a large share of the population is in the age group of 45 to 60. Those are people who often have good incomes and want to save to ensure adequate pensions after retirement. These savers are looking for medium to long-term investments which give a return, exceeding that of traditional bank deposits.

The competition for savings comes from many sources. In Sweden, specialised players such as niche banks can offer somewhat higher deposit rates because they operate with very low "overhead costs" in the form of branch offices and large personnel. Even food and petrol retailers offer favourable savings instruments which attract customers. Moreover, people increasingly prefer to invest in securities, either directly or indirectly via various forms of mutual funds.

In addition cross-border financial investment is rising. People are investing long-term savings more and more in assets issued in other countries. In Sweden, this trend is clearly accompanied by an accumulation of non-residents' investments in financial assets issued in our country.

In the case of *lending*, an increasing share is being arranged via the securities market. So far, the traditional form of "securitisation" has dominated. The "off-balance" type of securitising, in which banks originate loans and then resell them to special financial vehicle companies (SPVs) which issue securities against the loan stock has not yet really taken off, with the exception of the US and to some extent the UK. One reason for this may be temporary legal and regulatory hurdles, and it is quite possible that we in Europe will see a future growth similar to that in the US.

The development in savings and, even more so, in lending is strongly enhanced by the use of derivatives. With derivatives it is possible to hedge against risks, to separate them and to price different risks. Investors and borrowers may create exactly the risk composition they prefer. Also banks themselves can manage the risks in their portfolios by using derivatives. This does not mean the total elimination of risk. Banks are, and this is their main contribution to the general economy, risk-taking institutions. But their risks should be limited and well-known both to the management and to the public at large.

Banks have already responded in various ways to the developments mentioned above. The new technology has made it possible to offer a wide range of traditional banking services without having a large branch network. This has lowered the threshold for entering the banking market since a bank with few branches or a business concept based on the telephone or the Internet has a competitive advantage in certain, more standardised, market segments. In Sweden, we see that the traditional banks have responded to this by opening their own "telephone" or "Internet" branches. This has attracted a surprisingly large number of customers in a short time.

Going in the opposite direction, some trends may favour large banks. For instance, the fixed costs, in the form of branch networks but also in the form of sophisticated computer systems necessary to manage a global operation, needed to become a truly international bank are huge. Another example may be taken from the field of derivatives. In order for banks to minimise their credit risks and operational risks, banks have tended to prefer to deal with large and capital-strong counterparts thus increasing market concentration.

A recent development is called "outsourcing". Financial products are becoming more sophisticated and their design and production are increasingly dependent on expertise located outside the banks. Academics write about a tendency for banks to become a kind of broker with a number of associated firms that have specialised in different financial services. The bank makes these services available to the customers. The intrinsic value of the bank resides in the possession of a familiar and respected name (a brand name) and an existing stock of customers. Perhaps the bank will also be a specialist in its own right in some – but not all – financial operations.

This perspective is hardly specific to the academic world. The phenomenon described is relatively common in business. Many large business corporations are associated with strong competition, extreme specialisation, reliance on sub-contractors and the cultivation of brands.

The evolution of the financial system can be viewed as an innovation spiral, in which organised markets and intermediaries, such as banks, both compete with and complement each other. Financial markets tend to be efficient institutional alternatives to banks when products have standardised terms, can serve a large number of customers, and are well-enough understood for transactors to be comfortable in assessing their prices. Banks are better suited for low-volume customised products. As products such as futures, options, swaps and securitized loans become standardised and move from banks to markets, trade in these new markets expands. Success of these trading markets and standardised products encourages investment in creating additional markets and products.

There is nothing to suggest that the pressure and pace of the rapid change in the financial system will ease in the near future. On the contrary, the pace of development seems to be accelerating. The move to Stage Three of EMU will probably accentuate this. It can be noted, on the other hand, that a factor which has played a major part, particularly in the 1980s, namely the deregulation of financial systems and markets, is now largely completed in the West.

A stable environment

The process of transformation and evolution has not always been entirely painless in either the real economy or the financial sector during the course of history. The adjustments have from time to time proved difficult to varying degrees.

There are many episodes in the past that are easily recognisable as financial crises. The bursting of the "tulip mania" in 1636 which, in fact, was caused by the steep rise and fall of tulip bulb options proves that derivatives crashes are older than we might think. Other crises are the "South Sea Bubble" in 1720, the East Indian Company crisis in 1772, the collapse of the railway boom in 1846, the failure of Union Generale in 1881 and of Baring Brothers in 1890, the US. banking panics of 1873, 1893, and 1907, the failure of the Creditanstalt in 1931 and the worldwide bank collapse of the next two years and of course Black Thursday in October 1929.

The current developments likewise involve problems and difficulties. The past decade has seen bank crises in a number of countries as well as abrupt corrections or even wider fluctuations in share prices, interest rates and currencies. This has been the case in Sweden as well as elsewhere.

The internationalisation and transformation of the financial sector faces national and international authorities with a new, more complex environment. One can probably say that the very efficiency of global financial markets also makes them capable of transmitting mistakes at a far faster pace throughout the financial system than was the case a generation ago.

In a sense all major financial crises are unique and therefore difficult to prepare for and avoid. However, important steps can be taken to ensure that the conditions for a financial crisis do not arise. As we have seen, severe financial problems can be triggered either directly in the banking system or via a loss of international confidence and result in a currency crises. Fundamentally it is a matter of conducting a credible economic policy focused on price stability. This provides the prerequisites for a monetary policy reaction to excessive increases in asset prices and credit stocks that would be liable to boost inflation and create the type of speculative climate that paves the way to a financial crisis.

Accordingly, the economic policy focus in many countries on low inflation and sound government finance is making the general economic environment more stable, which favours developments in the financial sphere. In the context of rapid changes affecting financial markets disruptions are inevitable. The economic consequences of these disruptions will be minimised if they are not further compounded by financial instability associated with fluctuations in underlying inflation trends.

However, overseers and supervisors of the financial sector still face additional challenges.

International cooperation between different authorities is highly important, particularly as problems in one country are more likely now to spread to other countries, than earlier.

In addition, academics discuss the need of financial supervision in the context of the altered conditions in the financial system. One conclusion is that traditional supervisory regulations are still needed but must undergo a better adaptation to the current situation. I agree and can add that the authorities, together with the institutions concerned, are working in this direction. Financial operations have simply become so multifaceted that the traditional forms for supervision are no longer appropriate for every situation.

Financial legislation and supervision are moving increasingly towards a flexible situation bounded by certain statutory limits. There is thus a tendency to make market agents more accountable for the implementation of internal and mutual controls. This can be arranged, for example, by requiring detailed and transparent accounts so that outsiders can obtain a clear picture of a bank's financial position and risk status.

The role of central banks

Developments in the financial domain are of interest to central banks in the context of both our two primary concerns – monetary policy and the payment system. The supervision of the institutions in some countries is a matter for special supervisory authorities. It is important, however, that central banks have resources for an independent assessment of the various institutions, not least in a situation when a central bank, in its capacity as lender of last resort, may have to consider providing support for liquidity.

It is via agents in the financial system that monetary policy is implemented. Problems for the financial system affect the facilities for monetary policy's efficient execution. The banks also have a central function as the channel through which all liquidity in the economy passes. It is therefore important that the economic status of the banks is stable and that they operate efficiently and reliably. Otherwise the flow of payments may be disturbed. Should the problems become so great that they constitute a systemic risk, it is incumbent on central banks to consider support for liquidity.

Central Banks often also have a direct, operative role in the payment system in that we provide a system for the settlement of large-value payments. These systems are the hub of the payment system in that it handles inter-bank payments. We also have an interest in the operations of related agencies which undertake the settlement of the monetary policy transactions and provide central banks with loan collateral.

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To sum up, the financial system is undergoing a rapid transformation and development. The industrial revolution is usually considered to have started in the nineteenth century. Perhaps future historians will cite the late twentieth century as the beginning of the financial revolution.

This requires a great deal of various authorities. The government's and the central bank's role in supporting the infrastructure, in a broader sense, of the financial system is fundamental. At the same time the rapid development constitutes a great challenge to all of you who hold various positions in the financial system in order to avoid financial disruptions with potential risks for more or less severe consequences for the activity in the real economy.

As a central banker, I am doing my job by focusing on the problems and concerns which arise from these rapid and far reaching developments. Those of you who aren't paid to worry and indeed all of those using financial services, can build on the opportunities to add to the efficiency and productivity of the economy which these developments offer. In my view this financial revolution presents us with new problems to focus on but it is a revolution from which also great benefits can be derived.