Speech

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Financial globalisation

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First a word of thanks for the invitation to speak about financial globalisation.

As a result of all the developments in communications and information technology, together with the new instruments and methods they have provided for risk management, today's financial systems are far more extensive and efficient than ever before. We have good grounds for assuming, though we do not yet know for certain, that the rapid pace and internationalisation of financial developments are a logical and necessary consequence of ongoing general economic tendencies that are generating a need of new financial solutions for the business community as well as for households.

While the financial developments are indeed facilitating global economic growth, they also entail increased risks. Markets and players are becoming increasingly interdependent, both inside and across national borders. Today, a disturbance in one market segment or one country can quickly spread throughout the world economy. In recent years we have experienced financial crises that have stemmed from an excessively rapid expansion of credit in some countries, often combined with strongly inflated prices for assets such as shares and real estate.

Today I shall be considering some aspects of the financial system's development and the related demands on decision-makers in both the private and the public domains of our economy.

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A financial revolution

First of all it is important to bear in mind that the financial system has not been developed as an end in itself. Its purpose is to facilitate the production of and trade in goods and services. Neither is it a modern invention. People have resorted to financial transactions since time immemorial.

We are told that credit was used systematically in agriculture and other contexts in Mesopotamia as much as 5000 years ago. It was not until the 12th century AD, however, that banks were first established in Genoa, Florence and Venice, where they flourished in the coming centuries. Securities that resembled modern instruments also originated in the late mediaeval Italian city states. In Sweden, what we now call the Riksbank was founded in 1668; the first bank notes had been issued some years earlier. These notes—a form of receipt for deposited metal—were used for commerce. Neither are organised exchanges for trading and forward dealing in other financial derivatives a new phenomenon. Similar contracts were traded on a large scale on the Amsterdam bourse in the 17th century.

A historical appraisal shows that, in fact, financial activities like the provision of credit, investment in securities and other contractual transactions have a very long tradition.

Since the mid 1980s, however, the pace of financial developments has accelerated sharply. It is probably no exaggeration to say that the past decade has seen the start of a revolutionary process of change and transformation, with consequences that cannot yet be clearly discerned. It seems likely, though we cannot be sure, that some way into the next century the financial system will have become essentially larger. Deregulation, globalisation, advances in information technology and new methods for assessing and managing risks have all helped to initiate a dynamic process in which financial markets, institutions and instruments are interacting.

Here are some examples of how international financial flows are growing:

*The stock of international bond issues, which amounted to the equivalent of SEK 1,800 billion in 1980, totalled the equivalent of SEK 18,000 billion in 1995.

*The nominal stock of derivative contracts, which amounted to the equivalent of SEK 12,000 billion in 1985, totalled the equivalent of SEK 216,000 billion in 1995.

*The international assets of banks in the G-10 countries, which amounted to the equivalent of SEK 8,000 billion in 1980, totalled the equivalent of SEK 40,000 billion in 1995.

These figures are just one indication of the dramatic developments which international financial markets have undergone in the past ten to fifteen years. As far as Sweden is concerned, it can be mentioned that between 1986 and 1997 currency market turnover for transactions involving Swedish kronor rose more than eightfold, whereas both foreign trade and GDP at current prices only doubled. In 1997 the Swedish currency market had a daily turnover of SEK 100 billion, of which only 5 per cent was directly connected with trade in goods and services. This gives some idea of the past decade's financial developments.

Globalisation occurs in various ways. Credit is provided from countries with a financial surplus to those with a deficit, direct investment and portfolio investment are financed, banks and financial institutions in one part of the world establish a presence in other regions, trading in financial instruments and derivatives becomes broader and deeper, and so on.

New role for banks

The role of banks is changing. Traditional banking involves receiving deposits from the general public and transforming these short-term funds into longer loans to households and firms. This conversion of maturities is a vital economic function. The customer relationships of banks tend to be of a long-term nature and the resultant accrual of information is an advantage for the sound provision of credit.

This traditional form of banking is now undergoing changes. Growing competition for savings has been accompanied by the introduction of new credit arrangements. At the same time, the greater transparency that financial markets provide is weakening the competitive advantage of internal information.

Traditional banking is clearly under pressure from many sources and banks are working to adjust to the new situation. Further changes in the structure of the banking system and other matters are likely to occur in the coming five to ten years. Comparatively small banks will no doubt form larger units nationally as well as between countries. Smaller, more specialised entities will emerge and gain ground. These two tendencies may seem to contradict one another. In practice, however, larger units are needed to make costly investment profitable, while smaller units often provide a better setting for the development of knowledge and innovations.

The competition for ***savings*** is coming from many quarters. Specialised agents in Sweden—niche banks, for instance—are in a position to offer somewhat higher deposit rates because their operations tend to entail comparatively low costs. Even food and petrol retailers are now offering favourable account terms that attract customers. Moreover, people are increasingly opting to invest in securities, either directly or in the form of mutual funds. Saving trends often have a good deal to do with demographic factors. A large fraction of the population in Western countries is 45–60 years of age; many of these individuals have a good income and want to save in order to have enough on which to live after they have retired. These savers are looking for instruments for medium to long-term investment that give a higher return than conventional bank accounts.

Then there is the growth of cross-border financial investment. To an increasing extent, people are placing their long-term savings in securities issued in other countries. In Sweden, this tendency has its counterpart in foreign investors' growing holdings of financial instruments issued here.

As regards ***lending***, a rising proportion is being arranged in securities markets. The main form for this type of business borrowing has been direct market issues, for instance of commercial paper. Indirect 'securitisation'—whereby banks provide loans which they then sell on to specialised financial enterprises, who in turn issue securities against the borrowed capital—has not yet taken off except in the United States and, to some extent, the United Kingdom. Temporary legal and regulatory obstacles may be one reason for this; in the future it is conceivable that this form of securitisation will grow in Europe as it already has in the United States.

Derivative instruments provide a stimulus to the development of saving and, still more, of lending. They can be used to guard against risks by pricing them separately. Investors and borrowers can choose the combination of risks that suits their preferences. Banks themselves can use derivatives to manage the risks in their portfolios. This does not involve eliminating risks completely. Risks are inherent to commercial banking but they should be calculated properly and controlled by bank managements.

In the future, moreover, firms may use derivative products of various types to eliminate conventional commercial risks outside their core activities. Many firms already cover foreign exchange risks and interest rate risks. There is also the supply of insurance products—against theft, fire and accidents, for example—which are basically derivative instruments.

Banks have already responded to the rapid developments in various ways. The new technology has made it possible to offer a broad range of traditional banking services without recourse to a large branch network. This has lowered the threshold to the bank market and it tends to reduce costs because a bank with just a few branches or a business concept based on the telephone or the Internet has a competitive advantage in some of the more standardised market segments. In Sweden, the traditional banks are reacting to this by introducing their own telephone or Internet services. This has quickly attracted a large number of customers.

Looking in the opposite direction, there are certain tendencies that may favour large banks. A truly international bank has to be able to carry huge fixed costs, not just for a branch network but also, for example, for the sophisticated computer systems that global operations require.

A growing tendency recently is ‘outsourcing’. With the increasing sophistication of financial products, their construction and production are becoming more and more dependent on expertise which banks do not possess. According to some academics, in the future banks may operate more as commissioners, with a number of associated but independent companies that function as specialist suppliers of different financial services. In that the banks have a familiar and respected corporate image, they will be able to earn income by mediating these services. The banks themselves can also specialise in some—but hardly all—financial operations.

This vision of the future is not confined to the academic world. Outsourcing is already fairly common in the real economy. Strong competition, extreme specialisation, dependence on suppliers and the development of brand images are characteristics of many large companies.

Developments in the financial system can be described as an innovative spiral, where organised markets and intermediaries like banks both compete with and supplement each other. Financial markets tend to be efficient institutional alternatives to banks for products that have standardised terms and can therefore be offered at favourable prices. Banks are more appropriate for tailor-made products with a relatively smaller turnover. As products like forward contracts, options, swaps and securitised loans become standardised and are transferred from banks to markets, trading in these markets grows. The success of these trading markets and the standardised products stimulates the banks in turn to create new markets and products.

There are no signs that the very rapid pace of and pressure from changes in the financial system will ease in the foreseeable future. On the contrary, the pace seems to be accelerating. This will presumably be accentuated by the move to Stage Three of EMU.

A stable environment

History contains many episodes that are readily identified as financial crises. One instance is the ‘tulip mania’ in the Netherlands in the 17th century, when tulip bulb prices were driven to exorbitant heights by financial speculation before the market suddenly collapsed. Other examples are the South Sea Bubble of 1720, the crisis in the East India Company in 1722, the collapse of the United States railroad boom in 1846, the runs on American banks in 1873, 1893 and 1907, and, of course, Black Thursday in October 1929 and the worldwide bank failures in the following years.

The course of events continues to produce problems and difficulties. In the past decade there have been bank crises in a number of countries, as well as abrupt corrections in share prices, interest rates and exchange rates. Sweden in the early 1990s is one example, others are Mexico a few years ago and Asian countries at present.

The Asian countries with financial problems display several basic similarities with what happened in Mexico as well as Sweden. One common feature is the financial developments during a boom period that led to greatly increased vulnerability. Some of the elements in this process are a rapid expansion of credit, inflated asset prices and current-account deficits with the associated external borrowing. Sooner or latter the high activity slackens and asset prices start to fall. Heavily indebted firms and households find themselves in difficulties and the banks are hit by lending losses. Foreign creditors draw in their horns and the problems in the banking system are accentuated by an exchange rate crisis.

With the internationalisation and transformation of the financial sector, national and international authorities face a new, more complex situation. It can be said that the greater efficiency of the global markets also means that mistakes now spread throughout the financial system very much more quickly than a century ago. It is against this background that the efforts of the International Monetary Fund, as well as Sweden's contribution, to tackle the crisis in Asia should be considered.

In that every major financial crisis is in some sense unique, prevention and readiness are difficult. But important steps can be taken to ensure that conditions which induce financial crises do not arise. As we have seen, serious financial problems may be generated either directly in the banking system or via a loss of international confidence and the attendant exchange rate crisis. What it all boils down to is the need for a credible economic policy focused on price stability. This sets the stage for a prudent monetary policy response to an excessive increase in asset prices and an expansion of credit that might otherwise fuel inflation and promote the type of speculation that paves the way for a financial crisis. This is why economic policy in many countries is directed at low inflation. Sound government finances make the general economic environment more stable and this in turn promotes the stability of the financial system. Because of the rapidity with which changes affect financial markets, shocks are still bound to occur. But their economic consequences will be less serious if they are not compounded by the financial instability that attends a volatile rate of inflation.

However, financial system overseers still face challenges. International cooperation between different authorities is extremely important, particularly now that problems in one country tend to spread to other countries more quickly than before. There continues to be a place for traditional regulations but they must be brought better into line with the prevailing situation. Financial operations have quite simply become so varied that the traditional control arrangements have ceased to be appropriate in every case. There is therefore a tendency to make market agents more directly responsible for the implementation of internal and general controls. This can be arranged by, for example, requiring detailed and open accounts, so that different agents are able to obtain a clear picture of a bank's financial position and risk status. The problems in Asian countries, for instance, may have been exacerbated by the lack of distinct and transparent accounting regulations

The role of central banks

The course of events in the financial domain is of interest to central banks because it affects both of their primary concerns: monetary policy and the payment system. In some countries a separate authority is specifically responsible for the supervision of financial institutions; in Sweden, for instance, this function is discharged by the Financial Supervisory Authority. Even so, it is important that central banks have the resources to make an independent assessment of the various institutions, not least in a situation that requires the central bank, in its function as lender of last resort, to consider the option of supporting liquidity.

Monetary policy is implemented through the financial system. Problems in the financial sector accordingly affect the feasibility of conducting monetary policy efficiently. Banks also have a central role as the institutions through which all liquidity in the economy is channelled. Their financial position must therefore be stable and their operations must be conducted efficiently and reliably. Otherwise the flow of payments may be disrupted. If the problems become so large that the system's overall stability is at risk, it is incumbent on the central bank to consider supporting liquidity.

Many central banks also have a direct, operational function in the payment system in that they provide facilities for the settlement of large-value payments. In that these facilities handle inter-bank payments, they constitute the hub of the payment system. Payments totalling several hundred million kronor are handled daily in the Riksbank's RIX system.

Conclusion

To sum up, the financial system is undergoing rapid changes and development. The industrial revolution is commonly considered to have begun in Sweden in the 19th century. Perhaps future historians will date the inception of the financial revolution to the late 20th century.

Much will be required of the competent authorities. The central government and the central bank have fundamental functions in supporting the financial system's infrastructure in a wide sense. At the same time, for all those engaged in the financial system the rapid pace of developments is a major challenge when it comes to avoiding financial disturbances and the associated risks of consequences of varying severity for real economic activity.

At the Riksbank we focus on those problems and concerns that are liable to arise in connection with these rapid and far-reaching developments. Other agents in the financial system should do likewise. The financial revolution poses challenges that we must square up to; but it is also a revolution that is likely to be highly beneficial for the future growth of the global economy.