Speech

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Is there a need for a new global financial system?

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A long period of recurrent financial turbulence

The situation of the world economy has to a large extent been formed by the consequences of the financial turbulence that has affected many countries in recent years.

The crisis in Japan has continued throughout the 1990s and the problems in Asia are now in their second year. Last autumn, Russia was obliged to devalue and moreover opted to suspend payments on part of the central government debt. In addition may be mentioned the major problems experienced by the hedge fund Long Term Capital Management last autumn. The LTCM crisis resulted in an extensive, but thankfully temporary, turbulence on the financial markets of the western world. During recent months, Brazil has also encountered difficulties.

All these events have in one way or another entailed various kinds of adjustments in the respective country and resulted overall in a dampening of activity throughout the world economy. In addition, there is a risk for further spreading of

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the financial turbulence to other countries and that a correction will take place not least in the US stock market.

During the past five to ten years, the road ahead has been accompanied by financial turbulence at many places throughout the world. In 1994 Mexico ran into difficulties. Before that we had bank and currency crises in the Nordic area and not least in our own country. The ERM system was also affected by extensive turbulence in autumn 1992 and in summer 1993. As a consequence of this, the band widths had to be expanded and several countries move over to a floating exchange rate. The fact is that more than a dozen serious bank crises have occurred during the past twenty years, each of which has led to direct central government expenditure of 10 per cent or more in relation to GDP. In addition to this, there are the indirect consequences that follow in the wake of these crises in terms of lost production and increased unemployment.

Against this background, the natural questions are what we can do to prevent this type of events and when they occur, what can be done. The title of my speech today is: *Is there a need for a new global financial system?*

Let me say right away that I will not touch more than superficially on a number of important, difficult questions. The time at my disposal is short and this title deals with very complicated material that we do not have full knowledge of by any means. This is also why extensive work is being carried out at both international and national level to analyse the financial problems and work with various kinds of solutions.

I am going to begin by giving a short description of the background to what has taken place, as I see it. This gives an indication of what the problems really are. First thereafter, it will be possible to begin to approach the question of what we can do about it.

Some causes of the financial turbulence

In order to be able to describe briefly what has happened, the financial developments must be viewed in a broader perspective.

During the past twenty years, the financial system has been deregulated in many countries. Capital can now once more for the first time since the outbreak of the First World War pass more or less freely across national borders. Moreover, major changes have taken place in communication and information technology, which has led to new instruments and methods for risk management. Taken as a whole, this has led to the financial system being more extensive and global today than ever before. This also applies even though capital flows in relation to GDP were also large at the end of the last century. However, it was other countries then that were the recipients of the flows of capital and they also partly took another form.

The rapid financial development and internationalisation are *per se* a logical consequence of the production of goods and services being globalised and the rapid increase in cross-border trade in the world economy. This has in turn increased the need for new financial solutions for businesses and households. When the exchange of trade and globalisation of production of goods and services increase, there is also a demand for the financial system to be developed and internationalised in order to be able to make full use of the opportunities for increased prosperity. However, the transition to a more global financial system has not been without problems.

Developments have often taken place too quickly for the system to be able to really keep pace. We remember this not least from the 1980s in Sweden. Neither the banks nor the public authorities had the right prerequisites to be able to adapt to the new conditions that a freer capital market entailed. The expansion of lending not infrequently took place on a loose basis and the authorities did not follow up development sufficiently. This also applied at the micro level, i.e. at individual banks, and at the macro level. The economy overheated and asset prices rose strongly. Furthermore, the fixed exchange rate stimulated an extensive short-term borrowing abroad. This was channelled through the banking system and brought about a considerable vulnerability. When the trend reversed, the adjustment was violent. Production fell, unemployment rose and the banking system encountered an acute crisis.

Although every type of financial turbulence that occurred in different countries in recent years is naturally unique, there are a number of similarities with our experiences in Sweden at the beginning of the 1990s; an immature banking system, inadequate supervision, an economic policy that was not designed to take into account the effects of credit and foreign exchange deregulation and a fixed but adjustable exchange rate that stimulated exaggerated cross-border movements of capital. Moreover, it has been seen that the demands on bank accounting were pitched at too low a level in many countries.

An important factor that contributed to worsening the problem in the financial sector is macro policy. In order for a free capital market to develop in a stable way, a consistent and predictable economic policy is required. Major macroeconomic imbalances which must sooner or later lead to drastic policy measures create turbulence on the financial markets. The policy that central banks around the world have been given the task of pursuing has the prerequisites for leading to a stable macroeconomic development. A clear and credible price stability goal should be positive for the stability of the financial system.

The high inflation created, together with credit and foreign exchange deregulation, a speculative climate in many countries. Sweden was an example of this. Correspondingly, in the industrial countries, the work of getting away from a high inflation economy has subsequently created strong increases in share and bond prices. The shift from high to low inflation has led to considerable falls in

interest rates, which have in turn created extensive capital gains in the share and bond markets.

The fact is that during the past fifteen to twenty years, the American share and bond markets, taken as a whole, have experienced the strongest upswing in modern times. Parallel with the increase in wealth, an almost explosive expansion of the financial sector has taken place in USA to meet the new interest for investments and other financial activities. I take the USA as an example since it is such a dominant economy but many other countries have experienced the same thing. Moreover, the American capital market is so large in a global perspective.

Share prices in the USA have increased in real terms by approximately 16 per cent per year since 1982, which shall be compared with an average of between 6 and 7 per cent during the past 120 years. In a corresponding way, investments in bonds with a long term have produced an annual real yield of around 11 per cent. The corresponding historical average is only 3 per cent. There has quite simply never been a time in history when both shares and bonds have been such a good investment for such a long period of time. This has in turn created a climate with high risk-taking, including a markedly increased interest in extensive borrowing and complex, financial instruments.

The long period with very high yields on financial assets has made investors and banks accustomed to this level. This has in turn led to a very steady search for business transactions that can correspond to this yield requirement. This has in turn stimulated the growth and expansion of the financial sector.

The convergence of long interest rates in Europe has offered attractive investment alternatives for a major part of the 1990s. An extensive capital flow from the US to Europe has therefore taken place. When the Danish referendum in summer 1992 created doubt as to whether it would be possible to establish a monetary union in Europe, this led to a dramatic reversal of capital flows and a marked financial turbulence arose in Europe. Eventually, the short-term oriented investors returned, only to change their behaviour again in spring 1994. They were then affected by the change of course of US monetary policy. The increase in short interest rates in the US then pulled up long interest rates in Europe for a period.

The opening for capital investments in so-called emerging markets created an opportunity for achieving high returns. Between 1990 and 1997 over 400 million US dollars flowed to Asia alone. This was equivalent to around 25 per cent of these countries' aggregate GDP during a year. It was a combination of bank lending and portfolio investments. Towards the end of 1997, international banks had lending amounted to over 350 billion US dollars, of which 60 per cent was short-term. It is, of course, in itself positive that capital moves from one part of the world to another if the yield is seen to be higher. However, the problem was that the conditions for productive investments did not prove to be as good as it was hoped. When the Asian problems later became obvious, the capital flows reversed and serious financial turbulence broke out.

A third way of retaining a high return was to increase risks by a combination of debt financing and using complex financial instruments. This created the starting shot for so-called hedge funds of which some used a very high leverage. Long Term Capital Management was one such extreme example. In this case, the leverage was more than 50 per cent of equity. This implies a debt to equity ratio of a mere two per cent.

The international banks engaged in lending directly to countries where the returns were high. Moreover, they lent capital to hedge funds that invested in the same countries. In certain cases, the banks also directly owned shares in these funds. It is justified to say that risk-taking was high in many cases. It was viewed as a natural way of retaining what was in historical terms an unusually high real yield level. In turn, the good profits created a culture of deceptive security and stimulated further risk-taking. To this can be added, the false security created by the new mathematical models that had developed. They were seen to function well in normal times but not when they were best needed, i.e. when turbulence arose.

Sooner or later expectations in the western industrial countries on the return on financial investments must be adapted to what is sustainable in real economic terms. Moreover, the various events that have taken place lead to the financial system consolidating itself. However, a number of steps need to be taken for the financial system to function better.

What can we do to prevent financial turbulence?

The current problems in the global financial system and their repercussions require both short-term and long-term measures.

In the short-term, an economic policy focused on stability is of key importance

In the short term, the problems in the world economy must be solved locally through a macro policy focused on stability. The international community has in a number of cases contributed with liquidity provided that the country in question has been prepared to take steps in the domestic sphere that have addressed the core of the problems.

The financial crises almost always have their origin in an unsuccessful economic policy. The international financial markets have possibly contributed to make problems come into light earlier and to their spreading, but capital movements as such are not the basic problem.

Central banks around the world have contributed to softening the systemic effects within the framework of their objective of working for price stability. The risk of a very serious situation as a result of the collapse of LTCM during the autumn was

averted, for instance, by the swift and resolute action of the US central bank. The threat of a so-called credit crunch due to the LTCM crisis could thereby be avoided.

The real economic consequences of the Asian crisis and the financial turbulence triggered by the Russian devaluation and suspension of payments, as well as the collapse of the American hedge fund LTCM, continue to dampen growth and inflation in the world economy, however. All the indications point to their continuing to do so during the next few years, in the perspective that is presently relevant for monetary policy.

For Sweden, the deteriorating prospects for international growth have a dampening effect primarily through weaker growth prospects for exports. This also has repercussions on industrial investments. However, consumption should develop relatively strongly. A good confidence in economic policy in general together with the Riksbank's interest rate reductions can be an indication that the coming downturn will be counteracted to some extent. In connection with the Riksbank now preparing its report to the parliamentary standing committee on finance, which will also be the first Inflation Report of the year, we must, however, consider in more detail how the prospects for inflation are affected by the probable development of the real economy.

One difficulty in this analysis is that there is a clear difference throughout the whole of Europe, including Sweden, between the view of the future on the part of households and businesses. Households are very optimistic while businesses are gloomier. Historically, this type of difference is very uncommon and sooner or later the assessments must converge. Unless there is an international upswing, it is probable that households will eventually become less optimistic. The reason is that the businesses' view can be expressed in revised production plans, a reduced need for labour, and in this way reduce household optimism.

At the same time, the view of businesses may change. In this case, the reason might be, for instance, that the state of the U.S. economy continues to be so strong that it would act as an engine for the world economy.

However, there are also risks here. A number of imbalances are building up in the U.S. economy. Private consumption is developing considerably more strongly than households´ disposable incomes. Business investments are also increasing more rapidly than profits. Consumption and investment are underpinned by the strong development of the stock market in the US. This contains an important risk for a downturn in the world economy. A correction of the highly valued stock market can lead to a considerable dampening of the level of economic activity in the US, which in turn would affect the rest of the world economy.

In the long run, the US stock market cannot continue to produce real yields in two digit figures. When the interest rate situation has adjusted to the new situation with sustainable low inflation, the yield on shares will be dependent on the

underlying development of profits in the businesses. Since the real growth of GDP is a measure of how much wages and profits are growing over time in the US economy and the relationship between these is largely constant in the long run, share prices cannot grow substantially more than GDP in the long term. This indicates therefore that expectations on the real yield on shares will sooner or later be revised to one-digit figures. And what is involved here is a total yield including dividends.

The downturn in these expectations is still something in front of us. The so-called P/E ratio for the US stock market is still at a historically high level, which includes a discrepancy between the total of profit expectations for individual companies and for the US economy as a whole. Not even the most optimistic assessments of future improvements of productivity at the macro level can motivate P/E ratios as high as those at present. An adjustment of the real yield expectations on shares can take place in different ways, however: either a quick and large correction or through an adjustment over a protracted period.

These are some of the aspects that the Riksbank must analyse now that the Inflation Report is being drafted. There is also reason to bear in mind that the Riksbank is carrying out a monetary policy that is independent of the actions of other central banks. Our analysis can, of course, be based on the same factors, but our action takes place independently of others' decisions. The inflationary prospects of the Swedish economy are at the centre of our monetary policy decisions. It is these that are decisive for whether the repo interest rate is kept unchanged or needs to be adjusted downwards if the target of 2 per cent inflation is to be achieved in one or two years. In our assessment, we correct for so-called temporary price effects in accordance with the monetary policy objectives decided upon by the Executive Board of the Riksbank.

In the long term – institutional changes

In the long term the regulatory and supervisory framework in the various countries must focus on counteracting the risks for the type of turbulence that we experienced especially during the 1990s. It is also important that we develop the regulatory framework at the international level.

Fundamentally, it is the provision of credit that has been at the centre of the course of events that has occurred during the 1990s. Extensive credit risks have been the problem and the banks seem to have repeated similar mistakes time and again. These may concern domestic banks' excessive willingness in financing private borrowers’ investments in assets or the willingness of international banks to make foreign exchange available to their domestic counterparts. The concentration of lending to financial institutions is often high, which worsens the situation at times of financial turbulence. There may also be other reasons to wonder whether credit risk assessments have been as careful as one might expect.

What is the cause of this? One reason is probably the difficulties encountered by both banks and supervisory authorities in assessing the risks of a credit commitment. Credit risks are difficult to deal with and it is not easy to shed adequate light on the actors' credit portfolios. Genuine difficulties in assessments is then one explanation, another is that the banks in certain cases do not even seem to have carried out their own independent risk evaluations but have allowed themselves to be swept along with the tide.

Undervalued credit risks would therefore seem to be a recurrent theme in the crises that have arisen. It is therefore the banks themselves that must create a better credit policy in their institutions. This credit policy must influence everything from the work of the individual credit processor work to the more comprehensive strategies of the managing director and board. However, this is not sufficient, or rather: it is not probable that this would happen unless action is taken at the same time by the regulatory and supervisory authorities. The provision of credit by the banks and their conduct generally is namely affected by the expectations these have as to how agencies will act if a crisis occurs.

An extensive international work has focused on trying to come to grips with these problems. Authorities and financial market participants try together to formulate and introduce international principles for well functioning supervision, so-called core principles. A component of this is how to work out more meaningful capital adequacy rules that take into consideration the nature of the banking system today. The earlier capital coverage rules were based on the financial reality that existed in 1988. An overall review has been carried out and will be presented in April. In addition to this, an attempt is also made to achieve a higher level of transparency and disclosures through reporting. Increased transparency should lead to lenders avoiding taking unsound risks, at any rate due to lack of information.

Conclusion

The recurrent crises in the financial markets clearly show that the efforts to reinforce the system involve continuous effort - and a lot remains to be done. The banks and other financial institutions in recent years have achieved a lot to improve risk management, not least with respect to the credit portfolio. However, developments in the financial sector are so rapid that neither financial institutions nor authorities can be complacent. The developments of last autumn are a striking illustration of this.

However, we must be aware that the extensive work that is being carried out to strengthen the financial system does not imply that the system will be wholly protected from problems in future. Work must be focused on softening the effects and trying to ensure that the crises that do occur will not be so extensive and expensive for the macro economy as those we have experienced in recent years.

The aim of this work must then be to try to combine the necessary regulation and supervision of the markets with the benefits that a well-developed financial system can provide. For various reasons, special regulation and supervision of financial companies is required. However, this must take place in such a way as not to suffocate the development potential that can contribute to greater prosperity in the world economy.