Speech

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Global capital: advantages, problems and remedies

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First a work of thanks for the invitation to talk here about the global financial markets. Many of the questions raised by financial developments in recent years are clearly connected with foreign policy.

The crisis in the international financial system that began in Asia in summer 1997 developed, to cite President Clinton, from being just 'a few small glitches in the road' into 'the worst financial crisis in fifty years'. The extensive financial turbulence has fuelled the debate about globalisation and the increasingly integrated world economy.

In certain respects it can be said that, compared with the present situation, the degree of economic integration was greater at the beginning of this century. Expanding trade was accompanied by innovations that simplified international dealing. A common currency was available in the form of gold. In the years before World War One the net financial flows between countries, represented by current-account deficits, were even larger than today. In certain periods, moreover, migration was higher than at present.

All in all, however, integration is presumably more extensive today. Many more countries are now participating in the global exchange, gross capital flows are larger and market reactions are much swifter. New technology has paved the way

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for continued integration and is likely to go on contributing to further developments in this direction.

Against this background my talk today focuses on global capital: its advantages and problems and the remedies for the latter that are being discussed internationally. Let me begin by looking at what has shaped the global financial markets as we know them today.

Emergence of today's global financial markets

Today's global financial markets largely date from the 1970s, when the oil-exporting countries needed to invest surpluses and many western countries had incurred budget deficits that had to be financed. There was thus a need for a more efficient international market for capital. Another factor behind the development of financial markets was that after the collapse of the Bretton Woods system in the early '70s, the major world currencies started to float in relation to each other. This generated a demand for instruments that would render the exchange rate movements less deleterious for exporters and importers.

The evolution of the financial markets has been promoted by rapid technical advances that, besides facilitating international communications and transactions, have aided calculations and made advanced financial instruments available. This has been accompanied by theoretical work on the pricing of risks. A market for risks has accordingly been established. Instruments whereby players could choose a particular level of risk had existed for centuries but could now be made more sophisticated.

Before the financial markets could be globalised, moreover, national economies had to be opened up and the existing capital controls abolished. This process got under way in the 1970s and '80s. The players in financial markets had found ways of getting round the regulations, which in some cases had thereby become virtually toothless. In Sweden, for example, the capital controls had gradually lost much of their bite; companies were able to take up exchange positions, for instance, by shifting trade credits over time. There was also a growing awareness that economic growth would benefit from fewer controls. The interventionist line of economic policy had not been particularly successful. The pace of deregulation varied from country to country and the process was rather protracted. Britain and the United States led the way. Sweden was one of the last countries to abolish controls on cross-country flows of short-term capital.

Since the 1970s, financial market turnover has risen markedly and is now very much larger than the flows generated by global cross-country trade in goods and other services. According to the latest BIS study, from 1995, global exchange market turnover, for instance, was 1200 billion dollars, which is approximately five times the value of Sweden's annual GDP. The figure is roughly twice the level at the end of the 1980s. A new BIS study, for 1998, is due next week and can be expected to show a further increase in global exchange market turnover. Equity and bond market turnovers have also risen rapidly.

To some extent, the nature of the flows as well as the players in international financial markets have changed. The earlier domination of investment and borrowing is giving way to increasing flows from transactions in securities. New players have become more and more important. The quest for the best possible return on private savings is giving insurance companies, pension funds and highly leveraged funds a dominant position. Whereas the players used to be a more homogeneous group, consisting mainly of banks, households are increasingly opting to have their savings managed more actively than simple deposit accounts. While these changes have occurred in the various national financial markets, they have obviously also had consequences for the international capital flows.

Advantages of free capital flows

International financial markets that are free and integrated can enhance global growth through more efficient resource utilisation. Savings can be channelled to the best investment opportunities, unrestricted by national borders. Capital-importing countries can build up productive facilities, obtain access to modern technology and expand in sectors with relatively high productivity, while capital-exporting countries can earn a higher return. The industrialisation of Sweden in the latter part of the nineteenth century is a good example of what access to foreign capital can do; the construction of the railway network, for example, was financed with foreign loans.

Financial markets also make it easier for economic agents to manage risks so that the economy functions more efficiently. The wide variety of financial instruments enables investors and borrowers to choose their preferred level of risk. Some players may want to avoid all exchange rate fluctuations for a time, while others are prepared to take this risk in return for a premium; by operating in the derivatives market they can arrive at the appropriate risk profile.

Globalisation has led to increased competition across countries and markets and aided the emergence of new activities and structures. This in turn seems to have contributed to increased capital productivity—more can be done than before with a given capital input. It is just these factors—more efficient financial markets and higher capital productivity—that are often cited as the main forces behind the American economic miracle: the combination of high growth and low inflation despite low saving.

Problems

The globalisation of financial markets is also dogged by some problems. It affects the scope for national economic policies. Moreover, financial market prices tend to fluctuate widely, sometimes for little apparent reason.

Before considering these issues, I just want to say a few words about the reality behind the notion of the financial market, which consists in practice of various categories of savers and borrowers. Besides private individuals, these include national, regional and local governments, small and large companies, high-risk hedge funds, banks, insurance companies and long-term pension funds. So the market cannot be reduced to what goes on in trading rooms, even though, for want of a better alternative, television's financial newscasting often visualises the market in such terms. Every saver and borrower exerts some influence on the market but naturally not to the same degree. The stage is set by the biggest players, be they individuals, companies or nations.

The scope for economic policy

Free capital mobility is sometimes criticised for encroaching on democracy and rendering economic policy less effective.

Even in a world with integrated financial markets, economic policy is decided by the national political systems. They are free in principle to alter tax rates, boost public spending and adjust interest rates whenever they wish. In this direct sense, a more open economy does not mean that policy is restricted. In many ways, access to international capital can actually enlarge the scope for action. Unlike the case in earlier centuries, a country that is stricken today by severe crop failures, for instance, can borrow external funds to buy seed. Similarly, a country wishing to strengthen its growth potential by more than domestic saving permits can expand its production apparatus more rapidly with the aid of imported capital.

At the same time, loans and other financial transactions do entail dependence. If a country's economic policy does not inspire confidence, the consequences may be unfavourable. Perhaps investors will no longer be prepared to provide new loans and may even stop existing credits. Long bond rates are liable to rise, accompanied by a depreciating currency. Such reactions are the market's way of passing judgement on economic policy and a country's creditworthiness. This mechanism is the same as that for private borrowers. Access to credit enhances welfare but also exposes the borrower to the scrutiny and discretion of creditors.

A good example of how this works is provided by the Swedish economy. From the mid 1970s, problems with government finances led to external borrowing, which mitigated the effect on interest rates. But debt accumulated and an acceleration of this trend in the early '90s led to an acute loss of confidence: interest rates shot up and after a time the krona fell.

Besides illustrating how a country can be hit if its economy is not managed properly or if problems arise from other causes, this example shows that the imbalances may be generated gradually, so that timely signals can be an advantage. Perhaps prompter warnings would have put a stop to the economic mismanagement at an earlier stage. Something may thus be gained from the market sending clear signals without delay.

But the situation should not be idealised. The functioning of financial markets is by no means perfect. Real economic problems can build up without attracting attention and when they are detected, the financial unrest is liable to spread to other countries for no apparent reason. The financial market's reaction may also be out of proportion to the underlying imbalance. This brings me to the next type of problem.

Financial instability in a global market

Just as in any other market, financial market prices are basically a function of supply and demand. This means that they are dependent on the path of economic fundamentals; in the case of government bonds, for example, the relevant factors include the budget balance, monetary policy and inflation expectations.

Financial asset prices are highly susceptible both to expectations of how the market *ought* to move, given the underlying conditions, and to how it *will* move, given the expectations of how other players will act. This can result in wide fluctuations. Prices may deviate for a considerable time from what could be regarded as their long-term equilibrium. Markedly inflated prices can result in 'bubbles', out of touch with the level that seems to be fundamentally justified. Examples of this are the developments in some Asian countries in the mid 1990s, as well as price movements in the Swedish property market around the turn of the '80s.

To some extent, such phenomena can be explained in terms of how economic policy is conducted. But the causes of large price movements are also to be found in the construction of financial markets. If a market is to function properly, all the relevant information should be available simultaneously to every player. In practice, that is evidently not the case. Moreover, financial players can act in the knowledge that what they do will influence the market. The fact that performance is assessed in the short run, in many cases in comparisons with other players, makes herd behaviour common. The risk models that are in use are liable to accentuate this phenomenon, even though such models are actually intended to do the opposite, namely minimise risk and instability. A signal from a risk model can trigger sales by numerous investors, whereupon prices fall still further. In this way, a mechanical application of risk models is liable to exacerbate price fluctuations.

Financial market globalisation also leads, as I mentioned initially, to increased capital flows. Low transaction costs and high liquidity enable individual investors to pledge assets in the market to a greater degree. This leads to closer links and more interaction between different markets; a player may take large positions not just in markets for different assets but also in markets in different locations. Price movements may be affected if market players lose confidence in a particular geographical market or incur losses that oblige them to dispose of other assets. Globalisation has naturally increased such contagious effects, as we clearly saw last autumn.

Recurrent financial crises

In many ways, global economic development in the past two to three decades has been outstanding. Annual growth since 1980 has averaged over 3 per cent. The rate in the industrialised countries has averaged just over 2.5 per cent as against almost 5 per cent in the developing countries. Many East Asian countries have achieved even higher growth and thereby a radical improvement in economic prosperity. But development has by no means been smooth. The Latin American debt crisis in the 1980s, the Mexican crisis in 1995 and the turbulence that started in Asia in the autumn of 1997 are some examples of the financial crises in recent decades. While the circumstances behind the various crises differed, they did have certain features in common. The extensive problems have usually arisen out of a combination of inadequate credit assessments by lenders and investors and shortcomings in economic policy.

In an initial phase, credit stocks have risen rapidly in connection with hopes of a high return and the perception of low risks, partly because investors trusted the financial system and the regulatory apparatus. A characteristic example is the developing countries that were transformed in the 1990s into emerging markets—the risks seemed to be virtually non-existent. When the inflow of credit reduced interest rate differentials with the rest of the world, this strengthened the notion that investment in these counties carried relatively small risks.

Exchange rate policy often contributed to the problem. Investors and creditors expected exchange rates to remain fixed. Cross-country interest rate spreads encouraged the use of foreign-currency loans for investment in domestic assets, often without matching the maturities of assets and liabilities. The countries' central banks were expected to carry the exchange risk and convert at the predetermined rate.

At some stage, however, there has been a reappraisal. Signs that the economies were less robust than expected have led to a sudden change in the perception of risk. This checked the supply of credit, which in some cases caused a dramatic increase in lending rates to these countries relative to countries with a better credit rating. Exchange rate pressure grew and there have been acute currency crises, with collapsing exchange rates and thereby increased uncertainty.

It seems that the stronger the inflow of credit in the first phase, the more serious have been the consequences in the second, with declining production and rising unemployment. The reversal of capital flows, if these were channelled through the banks, has also created difficulties in the financial system. In many instances the financial system proved to lack the resilience to cope with the huge flows.

The crisis that began in Asia in the autumn of 1997 had extensive contagious effects in other countries. Some of the latter were countries that had conducted a broadly judicious economic policy and were thus hit undeservedly. Singapore and Australia are two examples. Others were countries with their own economic problems. One was Russia, which was obliged to suspend foreign debt payments in August. This elicited contagious effects that hardly anyone had foreseen. The turbulence spread to financial capital's citadel when an American hedge fund, Long-Term Capital Management, encountered extensive problems that had repercussions throughout the US capital market.

Some of the crises that have begun in emerging markets have also been compounded by problems of a different sort. The Asian crisis, as well as other financial crises, included elements of nepotism and corruption. Bank lending was directed in some cases from the authorities or the government to favour specific interests. Factual information, from private as well as public sources, was unsatisfactory in many instances. As a result, appraisals of the countries' economic fundamentals were based on faulty information and sometimes even on expectations that the close links between the political sphere and, for example, the banks and corporate sector were a guarantee of government support should problems arise.

Can the functioning of financial markets be improved?

The crises have made it obvious that the financial system needs to be strengthened, both in individual countries and globally. Can this be done without losing the advantages I mentioned earlier? These matters are being discussed intensively in various fora where the Riksbank is represented, such as the IMF, BIS, OECD, G-10 and even in the European Union. The need to reconcile the desire for national sovereignty in these questions with free capital movements, as well as international surveillance and control, is a major political challenge. It is also a challenge with several dimensions: many different technical changes are needed to strengthen the financial system at the same time as forms for cooperation are developed and the question of who decides is tackled. Let me devote the rest of my time to these matters, arranged under four headings.

1. *Properly functioning economies*

The primary condition for creating a more stable financial system is perhaps that the economies function properly. Although the crises can be explained in terms of shortcomings in the workings of the financial system, the instability has almost invariably stemmed from macroeconomic and structural problems. A reasonable economic policy is, of course, not just a requirement in emerging markets but also a standing order in the industrialised countries. Yet it is barely five years ago that Sweden regained a fairly firm economic foundation after the profound crisis in the early 1990s. There are many parallels between the Swedish crisis and the crisis in Thailand, for instance.

An important factor here is, as I mentioned, the exchange rate regime. Experience has shown that exchange rates that are fixed but adjustable may often contribute to problems and currency crises. They presuppose that fiscal policy is capable of countering economic shocks at the same time as they invite speculation. In the debate it is therefore sometimes proposed that the emerging markets ought to set up currency boards (a system whereby all outstanding currency can be converted into some hard currency) or participate in some well-established regional monetary cooperation. These systems do demand just as much of policy but their stronger links are intended to confer greater credibility. There is a risk, however, of financial players being lured into a false sense of security, giving imbalances more time in which to grow. Another feature that fixed exchange rates and currency boards have in common is the negative effects they may exert on other countries if they have to be abandoned. This is clear from the Asian crisis. The alternative is floating exchange rates. They have the advantage of permitting interest rate adjustments to the needs of the domestic economy. But they also entail exchange rate fluctuations and their drawbacks. The problem of exchange rate regimes is being discussed internationally but a consensus has not been reached.

Financial market deregulation, moreover, must be adapted to the financial system of the country in question and supported by a consistent economic policy. To some extent, the developments in Asia probably had to do with an inappropriate sequence of deregulations; that was the case in Sweden in the 1980s and it resulted in problems. Short-term foreign currency loans made the countries vulnerable and subsequently resulted in currency outflows. The forms for deregulation have therefore been considered in the international discussions. The International Monetary Fund will be taking these aspects into account in future evaluations of individual countries. It is important, for example, that deregulations are accompanied by a reinforcement of the supervision of financial institutions and markets, so that any 'bubbles' are detected in good time.

2. *Strengthening systems*

A sounder macroeconomic policy improves the conditions for making systems more robust. This is necessary but not always sufficient. A reinforcement of the financial system's infrastructure is also needed. Such efforts are required both in the emerging markets and in the industrialised countries, as well as at the global level. The emerging markets must build up better systems for oversight and supervision. The IMF, the World Bank and BIS are all involved in this work. Knowledge must be enhanced. The rule systems in many Third World countries must also incorporate bankruptcy legislation, arbitration procedures, and accountancy rules that are fair and transparent.

Extensive and well-motivated work on reforms in also in progress in many industrialised countries. The tasks and methods of central banks and financial supervisors are being specified. Many private institutions are reviewing risk models and adapting them to the global reality. Conventional models must be augmented. Supervision also needs to be developed to cover new instruments and types of risk, risks that the Asian crisis has brought to the fore. The Basle Committee is now working to identify respects in which supervision may need to be extended, for instance to create standards for the bank's transactions with highly leveraged institutions. The problems in LTCM clarified the central importance of this.

At the global level, closer coordination of authorities' work on supervision is being called for; today, such coordination is confined to sectors. A Financial Stability Forum has therefore been set up and consists, at least for the time being, of representatives of the finance ministries, central banks and supervisory authorities in the G-7 countries, together with IMF representatives. The Forum met for the first time some weeks ago. Discussions are also in progress in what is known as the Group of Thirty-Three, consisting of the participants in the G-10 and some twenty emerging market countries.

In its country evaluations, the IMF will also be paying more attention to the development of the financial system. There is to be cooperation with the World Bank; these two organisations have agreed on a joint model for the appraisal of national financial sectors. These appraisals are to be based on the current minimum standards for banks and other financial institutions, a broad review of developments and risks in the country's financial sector, and other conditions such as legislation, accountancy rules, payment systems and financial markets, for example.

3. *Greater transparency*

A more stable development also calls for greater transparency. If the global capital markets are to function as intended, their players must know about the actual risks and be in a position to make realistic profit assessments. This in turn means that international organisations as well as governments, private companies and financial institutions must convey a fair picture of the prevailing conditions. As regards the IMF, increased transparency has been proposed in the country assessments, for example. A pilot project has been initiated for the voluntary publication of material about individual countries. Sweden has promised to participate in the project.

Transparency also applies to the individual countries and the private sector. One element in the recent crisis has been a misleading account of both private debt and the size of foreign exchange reserves in a number of countries. The standard for countries wishing to participate in the international capital market—the Special Data Dissemination Standard—is being revised to give a better account of the level of foreign reserves and the debt position in individual countries. At country level, moreover, a code for monetary policy transparency and measures for maintaining financial stability is being drawn up by the IMF together with BIS, central banks, supervisors, the World Bank and the OECD. A fiscal policy code is already in place.

4. Managing future crises

Even with these measures, we have probably not yet seen the last financial crisis. A readiness for the management of future crises therefore needs to be created. A central issue in international discussions is the distribution of risks among the parties concerned. While the IMF has been provided with additional financial resources, it neither can nor should be prepared to contribute the main part of what may be needed in a crisis. This is because expectations that any costs will always be carried by someone else can result in an overall increase in exposure to risks, the problem of moral hazard. Such expectations are liable to drive up credit supply and demand and can influence private agents as well as national policy-makers.

One way of dealing with moral hazard among private investors is to arrange for them to carry a larger share of the burden in a crisis. At the same time, there has been an ambition to construct any measures so that they do not have larger negative consequences later on, for instance by deterring banks from providing desirable credit. These two perspectives are liable to conflict. The discussion has focused on preparatory measures as well as steps that can be taken in more extreme situations. As regards the preparatory measures, it has been proposed, for example, that bond contracts be constructed so that the renegotiation of scheduled repayment can be authorised by a majority. Another proposal is that capital adequacy standards be constructed so as to limit the proportion of short-term interbank credits from industrialised countries to emerging markets.

Recently, moreover, a decision was reached on contingent credits to countries that are judged to have a sustainable economic policy and have nonetheless been hit by a loss of confidence and liquidity. This is intended to reduce contagious effects. The IMF also plans to promote increased contacts between the borrowers in the emerging markets and their private creditors.

If a crisis has already occurred—without there being a clause for renegotiation—credit to the country in question can be renewed instead by the lenders acting in concert. The central banks in the countries with the largest bank loans to the crisis area can then agree to try to persuade those banks to prolong the loans. That is what happened in South Korea; the credits were renewed when the banks' loans had been monitored.

Conclusion

Let me now summarise what I have said and draw some conclusions. The global capital markets are here to stay. They have contributed to the good economic growth in many countries in recent decades by providing capital efficiently.

At the same time it cannot be denied that the global capital markets can generate problems, as we have seen in recent years. There have been marked fluctuations and they have spread from country to country. Shortcomings in national economic policy have been the cause in many causes but not in all. Small countries with less liquid markets have been heavily hit when highly leveraged funds have shifted capital between markets. For some countries with a weak political and economic system, the capital movements have been sufficient to elicit political crises and considerable social costs. A part has also been played by problems in financial institutions in the industrialised countries, even in the very centre of the international financial system through the Manhattan-based fund LTCM. Last autumn the US Federal Reserve found it necessary to reduce the instrumental rate and take the initiative in solving the problem of credit.

Against this background it is not surprising that an active discussion is now in progress about what is called the new international financial architecture. International meetings are being held in quick succession. For the time being at least, it is a matter, as I indicated earlier, of renovating and extending the existing building rather than of executing drawings for a new one. A former British colleague wrote recently in the Financial Times that 'the work on the new international architecture should rather be called a plumbing activity'.

If the discussions have a common theme, it is risk: how risk is managed and priced, as well as who should pay for any mistakes. This brings me to the last aspect of the ongoing discussion: how power relationships in the world economy have shifted and the consequences of this for the institutions that regulate and supervise the global financial markets.

As many former developing countries become more central players in the world economy, the balance of power has gradually changed. These realities are not fully reflected in the institutional system that was built up at the end of World War Two, in Bretton Woods and elsewhere; the United States still has a major role in these institutions and so does Europe. Together with EMU, this raises many questions about future representation in the international bodies. Those of us who represent Sweden have the important but difficult task of maintaining our country's position in the international financial cooperation in a constructive way, despite several decades of relatively weak economic development.

Perhaps that should be a topic for a future discussion under the auspices of the Institute of International Affairs.

Thank you.