Basle 7 June 1999

Annual General Meeting: Address by the President of the Bank for International Settlements

The following are excerpts from the speech delivered by Urban Bäckström, Chairman of the Board of Directors and President of the Bank for International Settlements, to the Annual General Meeting held in Basel today, 7 June 1999.

At this point I should like to take a look at the global economy and consider some of the policy issues we face. There is now a much greater spirit of optimism about world economic prospects than was the case only a few months ago when we were all anxiously waiting to see what the fallout from the Brazilian crisis might be. It was not thought implausible that Brazilian inflation would get out of control, that Latin America would experience a renewed flight of capital and that the devaluation of the real would spark another round of devaluations, perhaps even extending back to Asia. With the memory of the repercussions of the Russian crisis and the near failure of Long-Term Capital Management all too fresh, the possible impact of such events on overextended global financial markets was another source of great concern.

In the event, none of these fears have materialised. The Brazilian situation itself appears to have stabilised, with the impact so far on other Latin American countries contained. Both the IMF and the OECD are now forecasting global growth of about 2¼% in 1999 and further acceleration into the new millennium. The United States is expected to see an orderly slowdown, Europe to pick up speed, South-East Asia and Latin America to recover convincingly, and output in Japan to cease to fall. Asset markets already seem to be counting on such an outcome. Equity markets have risen worldwide, rebounding to record levels in the United States and Europe. Capital inflows into Asia, including Japan, have supported sharp increases in share prices, and a number of Latin American sovereign borrowers have been able to tap international bond markets within months of the Brazilian devaluation. Credit and liquidity spreads in many markets have also fallen sharply, albeit not back to the excessively low levels seen this time last year.

However, these favourable developments should not lead us to conclude that the danger has passed. Indeed, the principal risk at this point is that the sense of urgency in the need both to manage current problems and to prevent the emergence of new ones will be lost. This would be irresponsible since there remain some evident threats to international financial and economic stability and, perhaps even more importantly, there may well be vulnerabilities that are not so evident. Recall that the scale of the Mexican crisis in 1994 was foreseen by very few. In South-East Asia the onset, duration and scope of the recession were all missed by the forecasting community. At this meeting last year, no one had anticipated the extent of the turmoil in financial markets that would be generated by the Russian devaluation and moratorium. The way in which rising credit spreads led to losses by highly leveraged investors, liquidity shortages and the virtual drying-up of some markets was generally not anticipated. Let us be honest with ourselves: the track record shows that there are many things that we do not understand and cannot predict. It would be highly imprudent simply to assume that all will be well.

If many unexpected problems have surfaced over the last few years, many expected problems have failed to materialise. Whether this means the fears were not justified in the first place, or rather that problems have continued to build under the surface, remains to be seen. Perhaps the greatest of the unrealised fears has been that the US economy would slow down sharply before spending elsewhere had recovered sufficiently to support the global economy. This has not come about, in large part because of the continued strength of consumer spending in the United States. But the coincidence of declining private saving rates and a widening current account deficit is a matter of continuing concern. If investors became less willing to hold the rapidly expanding external debt of the United States, a falling dollar might increase nascent inflationary pressures in the United States, even triggering a hard landing. Fortunately, this has not happened, though the sharp rise in the yen in the third quarter of last year and last month's CPI statistics provide illustrations of how quickly the unexpected can arise. Another fear, again related to current trade imbalances, has been that of rising protectionism. While such pressures have been kept under control to date given continued growth in most of the industrial world, the challenge of maintaining an open trading system would surely increase were unemployment to begin rising again.

Another concern has been that equity markets, particularly in the United States but also elsewhere in the industrial world, might fall back rapidly and in a disorderly manner. With personal saving rates now near zero in many of the countries with highly valued stock markets, a marked decline could well herald lower spending and growth. For some years now, many analysts have questioned whether the expected growth of profit rates implicit in equity prices has not been unrealistically high. At the same time, others have asserted that technological progress and corporate restructuring provide the foundation for a new economic environment that will support significantly higher profit growth in future. The evidence to date on the validity of this assertion is scanty. In the meantime, it is prudent not to ignore an abundance of evidence that markets are prone to overshoot on both the upside and the downside.

The expected acceleration in the growth of global demand reflects the recent easing of monetary policy in most industrial countries and many emerging market economies. This easing, including that following the autumn crisis in financial markets, has been made possible by continuing disinflationary trends arising in part from high levels of excess industrial capacity. Moreover, the loans made earlier on to finance this expansion of capacity, in Asia in particular, still weigh on the health of the international financial system and have provided a further rationale for monetary easing in many countries. The recent experience of Japan reminds us, however, that the efficacy of monetary policy may be limited by the zero nominal interest rate constraint, particularly if prices are already falling and this is expected to continue. Concerns that an associated decline in the exchange rate might serve to export deflation to others may be a further impediment to policy activism.

Nor are these the only constraints on the use of accommodative monetary policy. What also seems to have been reasonably well established by the events of recent years is that such policies can themselves contribute to turbulence in financial markets. Easy and low-cost financing over an extended period may drive up the price of financial assets, even at times when the rates of return on the underlying real assets are declining. This is what happened in Japan in the late 1980s and in South-East Asia subsequently, and may help explain the sharp rebound in equity prices in the last few quarters. Periods of monetary

accommodation may also lead to a more cavalier attitude to risk-taking on the part of lenders. Such tendencies are accentuated by competitive pressures to maintain or increase rates of return on capital. However, the build-up of excessive leverage sets the stage for the type of market turbulence seen in the wake of the Russian moratorium when investor sentiment suddenly reverses.

If there are limitations to the use of monetary policy in some circumstances, then other policies might have to be relied upon more heavily. Policies of microeconomic reform remain the top priority to spur non-inflationary growth. Given that the overhang of excess capacity will hold back investment in many sectors for years, it also becomes more important to deregulate and open profit opportunities in other sectors. If such opportunities could be augmented by more favourable labour market policies, which might themselves eventually build confidence by creating jobs, the potential for a significant strengthening of medium-term economic prospects would surely be enhanced. These microeconomic reforms could, in countries where medium-term fiscal consolidation is sufficiently advanced, also be supported by the countercyclical use of fiscal policy.

Given the costs and the difficulties faced in managing the successive crises experienced over the last few years, it is not surprising that considerable attention has been paid to how future crises might be avoided. One obvious insight is that affected emerging market economies must reform their domestic financial systems. Simultaneous restructuring of the corporate and banking systems, and a clear recognition and allocation of losses, is required if profitability is to be restored and sustained. Further progress in establishing a sound legal infrastructure covering both bankruptcy procedures and effective corporate governance would also seem very high on the list of priorities.

To say that the key to avoiding future crises in emerging markets must be found in domestic reforms is not to deny the international dimension of the problem. Excessive capital inflows and outflows did exacerbate domestic problems and steps should be taken to deal with the possible recurrence of such events. To begin with, the dangers inherent in adjustable peg exchange rate systems need to be clearly recognised. There should also be less hesitancy in using market-based prudential instruments to prevent the build-up of excessive external indebtedness. And finally, countries that receive capital inflows should also prepare for the day when the movement might reverse. Countries that are vulnerable in this regard should consider carefully the adequacy of their foreign exchange reserves, particularly when measured against their short-term external debt. Since large numbers of countries cannot build up their reserves by increasing their trade surpluses simultaneously, this would seem to argue for greater use of contingent lending facilities provided by the private sector. Given such arrangements, recourse to the new IMF Contingent Credit Lines would then add public sector to private sector affirmation that the domestic policies being followed by the borrowing country are sensible and sustainable.

If domestic self-help is the best response, even to problems with an international dimension, part of the solution may still be found in measures to change the way in which international financial markets sometimes operate. While financial liberalisation and international financial integration bring unquestioned benefits, they can also be subject to episodes of excessive risk-taking. In recent years, there does seem to have been imprudent lending, and not just to emerging market economies but also to borrowers

within the industrial world. In part this has been spurred by competitive forces. These seem unlikely to diminish as financial restructuring accelerates. However, the potential of public safety nets to distort incentives and breed complacency can also be discerned and these structures should be re-evaluated. It is important that all investors are held accountable for their decisions. The international community should also ensure that all investors and lenders play their part in the resolution of any future financial crisis and, to this end, should implement, inter alia, changes to international bond covenants that would facilitate debt restructuring should this become necessary.

The events of last year have also made clear that greater efforts are needed to strengthen the functioning of markets lest market processes themselves add to volatility during periods of stress. The expanded role of markets in channelling funds from surplus to deficit sectors and for managing a variety of risks is one factor making this imperative. Information asymmetries lie at the heart of market failure, and the market's way of resolving them can give rise to unpredictable outcomes. Ensuring that markets have adequate information about national economies, the strength of financial systems, aggregate positions in markets and the financial standing of counterparties is important. Equally, if not more, important is to ensure that market participants' approach to risk management reflects the full balance of costs and rewards implied in their decisions. Finally, it is also necessary to consider the micro-prudential policies that apply to individual firms in a wider setting, including the potential for unintended aggregation effects. Internal risk assessment procedures must recognise the interrelationships that exist between categories of risk before, not when, markets are under strain.

The fact that markets are becoming increasingly global means that efforts to promote financial stability must also become increasingly international. One underlying theme of the many meetings held last year at the BIS and elsewhere has been the need to involve directly the emerging market countries likely to be affected by the decisions taken to promote monetary and financial stability. This reflects a very practical consideration. Implementation will be an even bigger challenge than setting international standards in the first place, and a sense of shared ownership will materially improve the chances of such implementation. Allied with other incentives for change, including surveillance by peers, the IMF and the World Bank, progress can be made if we keep insisting that progress must be made.

Let me finish by noting my personal satisfaction that the BIS, and the various groups and committees which meet here, continued last year to make substantive contributions to the pursuit of both monetary and financial stability. These efforts will be taken further, with the assistance of additional input from the newly established Financial Stability Institute and the even newer Financial Stability Forum. Recent episodes of financial crisis and macroeconomic disturbance underline how much work still needs to be done. Yet there is considerable comfort in knowing that the global community is addressing these issues in a serious and systematic way.