Remarks

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Towards international financial stability

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Introduction

Financial stability is a topical subject in the light of events in the past decade—years that saw financial problems in a number of European countries as well as in Mexico and Asia, the devaluation of the rouble and suspended payments in Russia, considerable turbulence in western financial markets and financial unrest in Brazil. The crisis in the international financial system developed, to cite President Clinton, from being "just a few small glitches in the road" into "the worst financial crisis in fifty years".

The problem is that crises will always be intrinsically difficult to forecast. 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. In the last spring, no one had anticipated the extent of the turmoil in financial markets that would be generated by the Russian devaluation and moratorium. The ways in which rising credit spreads led to losses by highly leveraged investors, liquidity shortages and the virtual drying-up of some markets were generally not foreseen. The track record shows that there are many

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things we do not understand and cannot predict. That conclusion is underscored by a look at existing attempts to build early-warning systems for various types of crisis. Either these systems miss out on crises that actually occur or they sound the alarm for crises that do not occur.

Nevertheless, given the costs and the difficulties of managing the successive crises over the past decade, we must continue to devote considerable efforts to avoiding future crises and try hard to understand the kinds of vulnerability that lie behind them. The crises during the 1990s have revealed serious flaws not only in macroeconomic management but also, just as important, in the structure and regulation of the financial system in both debtor and creditor countries. The work now being carried out in various international fora is thorough and can be summarised under three headings:

- ***Crisis prevention***, including the development of good practice standards and transparency codes, and incentives for both borrowers and lenders to act prudently.
- ***Crisis containment***, including the establishment of official contingent lines and possible forms of private sector finance which may reduce the severity of any crisis.
- ***Crisis resolution***, where the emphasis is on possible ways of creating a more orderly environment for restructuring external debt, on principles to guide the restructuring of banking systems in the wake of a crisis, and on handling corporate insolvency.

Much of this work involves international institutions like, for instance, the International Monetary Fund, the World Bank, the Bank for International Settlements, the Basle Committee on Banking Supervision, and the OECD, as well as the newly created Financial Stability Forum.

However, the work, often hard, of implementing policies and codes lies with national authorities. These measures will contribute to improved financial stability only if countries actually adopt and implement them. A crucial ingredient in achieving this is of course to involve countries, formally or informally, in the development of the policies, codes and standards. But even if that is achieved, I know from my own experience how difficult the actual implementation sometimes can be, not least for political reasons. I would also like to make the point that today's favourable trends in the world economy should not lead us to conclude that the danger is over. Instead, policymakers throughout the world must continue to work on forestalling new problems both because some evident threats to international financial and economic stability still remain and because there may well be vulnerabilities that are not so evident.

The run up to the financial turbulence of the 1990s

During the past twenty years, the financial systems in many countries have been deregulated. For the first time since the outbreak of World War One, capital can again pass more or less freely across national borders. Moreover, major changes in communication and information technology have paved the way for 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 holds even though capital flows relative to GDP were also large at the end of the last century.

The rapid financial development and internationalisation are *per se* a logical consequence of the production of goods and services being globalised, with a massive increase in cross-border trade. They also have to do with growing wealth in many parts of the world. This in turn has increased the need for new financial solutions for businesses and households. The increasing globalisation of production and trade in goods and services generates a demand for a more developed and internationalised financial system so that the opportunities for increased prosperity can be used to the full. Note that this, as always, involves a trade-off between risk and return. It is of course possible to substantially increase stability, in the sense of lowering risk, by measures that result in very low returns. However the solution is not to turn back to a less turbulent, but also less prosperous past regime of capital controls.

The transition to a more global financial system has certainly not been free from problems. It should not be forgotten that extensive capital regulations entail a mispricing of risks. Deregulation then leads to desirable price adjustments. But it is often during these transitional corrections that financial problems are liable to occur. Changes have often occurred too quickly for the system, including the institutional infrastructure, to be able to keep up. In most cases, neither the banks nor the public authorities had the necessary prerequisites for adapting to the new conditions that were created by a freer capital market. The expansion of lending had too free a rein in many countries and the authorities did not properly monitor what was happening at either micro or macro level.

Economic overheating often followed the deregulation and opening up of the domestic financial system due to a rapid expansion of credit rapidly. Asset prices rose sharply and imbalances developed. Furthermore, in countries with a fixed exchange rate system, extensive short-term borrowing abroad was stimulated. A large proportion of these funds was often channelled through the domestic banking system and rendered this rather vulnerable. When capital flows subsequently reversed, the adjustment was often violent. Production fell, unemployment rose and both the currency and the banking system faced an acute crisis.

Apart from the actual process of financial market deregulation, there may have been other factors at work. The openings for capital investment in so-called emerging markets created opportunities for international investors for achieving high returns. Between 1990 and 1997, the annual flow to Asia alone was equivalent to around 25 per cent of the affected countries' aggregate GDP. This was a combination of bank lending and portfolio investments; 60 per cent of the lending from international banks was short-term.

That capital moves from one part of the world to another if the yield is seen to be higher is, of course, positive in itself. The problem lay in the conditions for productive investments being less good than had been hoped. Later, when the Asian economies ran into problems, the capital flows reversed and serious financial turbulence broke out.

A further way of achieving a high return was to take increased risks by debt financing and complex financial instruments. This created a starting point for so-called highly leveraged institutions. Long Term Capital Management was one extreme example.

International banks engaged in lending directly to countries where the returns were high. At the same time, they lent capital to hedge funds that invested in the same countries. In some cases, moreover, the banks owned shares directly in these funds. There are grounds for saying that risk-taking was high in many cases. The good profits created a culture of deceptive security and stimulated further risk-taking. To this can be added the false sense of security that the new mathematical models imparted. They were seen to function well under normal circumstances but failed to do so when they were most needed, i.e. in turbulent times.

Domestic policies, institutions and rules important factors behind crises…..

Although several of these factors may have played some part in the run-up to recent financial crises, it is important to bear in mind that financial crises almost always originate in an unsuccessful domestic economic policy and in the structure and regulation of the domestic financial system. While modern international financial markets have possibly contributed to an earlier appearance of crises and to their spreading, a deregulated financial system with free capital movements as such is not the basic problem. It is striking that several countries most affected by financial turbulence in the 1990s were relatively new participants in the international financial system without having first established a sound domestic financial system and a sound economic policy. That conclusion also holds for my own country, Sweden, which experienced a severe crisis in the early 1990s.

One obvious insight is, and I quote Fed-Chairman Alan Greenspan, "that participation in the international financial system with all its benefits carries with it an obligation to maintain a level of stability and a set of strong and transparent institutions and rules if an economy is to participate safely and effectively in markets that have become highly sensitive to misallocation of capital and other policy errors".

Thus, emerging market economies must reform their domestic financial systems, just as we did in Sweden after our crisis, if they want to enjoy the benefits of an open international financial system. Accordingly, further progress in establishing a sound legal infrastructure, covering both bankruptcy procedures and effective corporate governance, would seem to be very high on the list of priorities.

It is also important to understand the dangers inherent in adjustable peg exchange rate systems. It is still far too early to draw the firm conclusion that the only viable exchange rate regimes, in all circumstances, are a free float on the one hand and a currency board or a monetary union on the other. Nevertheless, one common characteristic of the main crises of the recent past—Mexico, Thailand, Indonesia, Korea, Russia, Brazil and, for that matter, my own country Sweden—has been that the authorities had adopted a more or less rigid exchange rate regime that ultimately proved to be unsustainable. One clear lesson seems to be that, in many circumstances, once a weak peg comes under fire, defending it is often a losing battle, especially if the exchange rate does not properly reflect the development in the real economy. Another drawback to a fixed, but adjustable, peg is that it may stimulate excessive short-term capital inflow and thus in itself generate vulnerability because the central bank is seemingly absorbing the exchange rate risk. Against this background, a key question is the appropriate exit strategy to another exchange rate regime or a timely adjustment of the pegged exchange rate should the need arise.

An additional insight is that the simultaneous occurrence of foreign exchange rate crises and banking crises is probably the single most important reason why some countries have suffered much deeper recessions when their currency pegs collapsed or came under a severe speculative attack. The contractionary shock to most European countries in 1992–93 was clearly much smaller than for Sweden and Finland in the early 90s and for Mexico in 1995 and Asian countries in 1997–98.

Thus, authorities in countries that receive capital inflows should prepare for the day when the movement might reverse. Countries that are vulnerable in this regard should carefully consider the adequacy of their foreign exchange reserves, particularly in relation to 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.

……but the international dimension should also be recognised

To say that the key to avoiding future crises in emerging markets must be found in domestic reforms is not to deny that part of the solution may still lie in measures that change the way in which international financial markets sometimes operate. While financial liberalisation and international financial integration bring unquestionable 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. That such forces will diminish as financial restructuring accelerates seems unlikely. 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 the past decade have made it clear that greater efforts are needed to strengthen the functioning of markets. 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 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. Internal risk assessment procedures must recognise the interrelationships that exist between categories of risk before, not when, markets are under strain.