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Press release

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Ref. No.: 17/2000E

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, 5 June 2000.

I would now like to discuss the current economic situation and a few of the major risks to continued economic and financial stability. The world economy entered the year 2000 in considerably better shape than many would have expected just a year ago. The date change itself proceeded exceptionally smoothly, with no significant disruptions in either computer systems or normal market behaviour. And after recovering to near its long-term average in 1999, global growth is forecast to continue to accelerate in 2000.

It is especially noteworthy that almost every region of the world has seen an improvement in performance. Southeast Asia, Korea, Russia and Brazil have all rebounded from their recent crises more strongly than expected. Many of the world's poorest countries, including some in Africa, are posting respectable growth rates. The US economy is enjoying its longest ever recorded expansion. Growth in continental Europe is picking up – especially in the larger economies where growth had been relatively weak. And there are signs of an incipient recovery in Japan.

The remarkable economic boom in the United States has undoubtedly made an important contribution to the strength of the global recovery. But so too has the achievement and maintenance of price stability around the world. Inflation in Brazil and many of the other countries most affected by recent crises was contained within single digits. Despite a substantial rise in oil prices and strong demand, inflation in the United States, Europe and other industrial countries also remained subdued over the past year.

It is a sign of how far we have come that the weaknesses and uncertainties that so preoccupied policymakers and market participants in late 1998 and early 1999 have given way to concerns about overheating in many countries. The acceleration in global growth has refocused attention on inflationary pressures – on sustaining the monetary stability that we have strived so hard to achieve in recent years.

The process of monetary tightening began last year in the industrial countries. The United States and the United Kingdom were among the first to raise interest rates, and they were followed towards the end of 1999 by the European Central Bank and most other industrial country central banks. Inflation rates have recently risen in a few industrial countries, and further increases in interest rates may be needed in the coming months to contain price pressures, particularly in those countries farthest advanced in the cycle.

An improving external environment helped emerging markets to maintain easy monetary conditions over the past year. But there too the bias must mostly be towards tightening. While Korea modestly tightened its policy stance earlier this year, a few emerging markets have attempted to resist a tightening of monetary conditions through exchange market intervention. This may be storing up trouble for the future.

Although the momentum of the world economy and the policy actions taken to date give grounds for optimism, I have two major worries: external imbalances and asset prices. These worries are neither new, nor lessened by the fact that the world economy has strengthened in spite of growing financial imbalances. We have witnessed too many crises in the last decade not to know that market confidence can shift suddenly. A soft landing is by no means assured. But we can improve the chances of a soft landing by appropriate monetary and fiscal policies, and by implementing further structural reforms.

External imbalances reflect differences in demand as well as the configuration of exchange rates. For current account imbalances to adjust smoothly, growth in the United States needs to slow to a more sustainable rate, and growth elsewhere needs to continue to strengthen. A firm commitment to deregulation and other structural reforms could boost consumer and business confidence in Japan. Demand is picking up in Europe, but more could be done to support growth. In particular, additional labour market, pension system and fiscal reforms would enhance investment opportunities in the euro area. Further liberalisation and fiscal consolidation would also help to improve the competitiveness of Latin America's industries, and thereby ease concerns about that region's widening current account deficit.

The adjustment of external imbalances will almost inevitably involve significant movements in the major exchange rates. While an appreciation of the yen is in the long term consistent with Japan's position as a net creditor, too rapid an appreciation in the short term could threaten to undermine the still fragile recovery. A sizeable appreciation of the euro is also likely to be part of the adjustment process. Since its introduction, the ECB has successfully maintained price stability, and its vigilance has helped to anchor medium-term inflation expectations at below 2%. This achievement will eventually be reflected in the euro's external value.

Better economic prospects have contributed to higher asset prices – of equities in particular. It is only natural that increased wealth is a source of satisfaction to the investing public. Nevertheless, certain important risks need careful watching.

The first risk is that imprudent lending could fuel unwarranted asset price increases – as so often in the past. Although there is little evidence to date of a general lowering of credit standards, credit growth in some smaller European countries has been very rapid and loans to finance equity purchases have risen sharply in a few major countries. Ensuring that investors are not sheltered from the consequences of their sometimes misguided investments is important for maintaining prudent lending standards. Investors should not expect that monetary policy will underwrite any particular valuation of equity markets.

A second and related risk is that high asset prices might lead to complacency about debt levels. Household and corporate balance sheets may look healthy when asset prices are stable or increasing, but what will they look like if prices fall? Similarly, debt servicing ratios for some emerging market countries may look sustainable when market access is improving, but what will happen if interest rates increase?

Rising levels of household and corporate indebtedness in the United States and some other industrial countries, as well as rising levels of external indebtedness in a number of emerging market countries, are based on expectations of continued strong growth in income and production. Earlier I remarked that the momentum of the world economy and the policy actions taken to date give reason for optimism. However, volatility is intrinsic to financial markets. Recent turmoil in stock markets as well as earlier crises in emerging markets demonstrate the risks of basing decisions solely on one central scenario, rather than allowing too for a range of possible – including worst case – scenarios.

Central banks are certainly not better placed than investors to decide whether the burden of interest and amortisation payments has risen too high relative to prospective growth. But to the extent that they affect price stability or financial stability, asset prices and debt ratios are among the many factors to be considered in the conduct of monetary and financial policy. Moreover, some debtors could do more to ensure that their balance sheets are sufficiently robust to withstand the various shocks to which they might be exposed. Emerging market borrowers, for example, could use the opportunities provided by better access to global capital markets to take out insurance against volatile capital flows, including by lengthening the average maturity of their debt and arranging contingent lines of credit.

Steps are being taken nationally and internationally to improve the pricing and management of risk in financial markets. The BIS and the Basel-based committees are making a major contribution in this endeavour. The Basel Committee on Banking Supervision is well advanced in revamping the capital adequacy framework, linking capital more closely to banks' risk exposures. The Committee on the Global Financial System has continued to monitor potential vulnerabilities in the financial system, examining practical ways to make it more stable. The Committee on Payment and Settlement Systems issued a consultative paper on the development of core principles for systemically important payment systems last December, and expects to finalise the principles by the end of this year. Following its third meeting in March, the Financial Stability Forum made comprehensive recommendations in three reports on capital flows, highly leveraged institutions and offshore financial centres. And the Financial Stability Institute has begun to play a leading part in disseminating best practices in risk management and financial sector supervision.

In conclusion, we have made significant progress in putting the global economy on a path towards sustainable growth. Yet the scale of prevailing external and internal financial imbalances obliges me to strike a cautionary note. For the recovery to continue, governments must persevere with labour market and fiscal reforms, with privatisation and deregulation, and with prudent budgetary policy. Central banks must continue to act pre-emptively to contain inflationary pressures. Maintaining price stability is the best contribution that central banks can make to continued prosperity.