Speech

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How do we create stability in financial markets?

Public hearing in the riksdag on "Economic policy in a global economy - is the Tobin tax an obstacle or an opportunity?"

Thank you for the invitation to come here. This is a subject that I am often asked to discuss in various parts of the country. There is considerable interest in the challenges facing economic policy in an increasingly internationalised world.

The credit market is central to a country's economy. Financial institutes are needed to mediate payments for households and companies, such as wage and invoice payments. In addition, the institutes mediate capital from savers to borrowers. This can comprise companies making investments or households buying their own home. All in all, a well functioning financial sector is a necessary condition for a country to achieve prosperity. However, mediating payments and lending money also involves taking risks.

The international foreign exchange market in turn links together the national credit and payment markets, so that payments in one currency can be exchanged for payments in another currency. This enables trade, investment and foreign aid between countries. International capital flows enable savings in countries with a capital surplus, after exchange on the foreign exchange market, to finance investments in countries with a capital deficit. Countries like Sweden have made use of the international capital market over the years, for instance, to finance large investments in the infrastructure. Historically, foreign loans and investment have played an important role in the growth and development of poor countries.

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The financial markets thus perform an important function in society. However, over the years we have seen that major problems sometimes arise in the financial markets. One example is the Asian crisis 1997-98. It is usually bank problems, resulting from bad loans, which lie behind such crises. When confidence in the banking system fails, both domestic and foreign savers flee the country, and a currency crisis may arise. The social costs of such a crisis are very serious. In the wake of the crises, there is often a focus on the globalisation process in general, and the international capital markets in particular. Demands have been made for measures to prevent the emergence of new crises. This has included renewed discussion of the proposal for a tax on currency transactions, what is known as the Tobin tax. However, I do not consider the Tobin tax to be the right method to use, as it does not solve the fundamental problem, namely incorrect assessments of credit and risks and the lack of capital in the banks to cover losses. Furthermore, I can see a number of risks if this proposal were adopted, although I will return to that later. I would first like to accentuate the widespread and laborious work carried out for many years, on both a national and international basis, to promote stability and prevent crises from arising, but without impairing the functioning of the markets.

Experience shows that a necessary condition for avoiding crises is to pursue a fiscal and monetary policy that is aimed at creating stability and that inspires confidence. The common denominator for countries that have experienced financial crises is that the problems were based on mistakes in economic policy and deficiencies in regulatory frameworks. The financial market is often merely the messenger illustrating the fundamental problems. It is important that the choice of exchange rate regime is in line with the economic policy pursued and with the capacity of the economy to adapt. Countries that have experienced currency crises during the 1990s have had fixed, but adjustable, exchange rates. Today, therefore, an increasing number of countries choose to have either floating exchange rates with inflation targets, or completely fixed exchange rate regimes, such as currency boards.

Experience also shows that it is necessary to have a general regulatory framework that is applied properly, and that contains norms and institutions, in order for both national and international financial markets to function well. Countries therefore cooperate in international organisations, such as the BIS, the central banks' organisation in Basel, to work together on producing norms for suitable regulations and norms in various fields important to financial stability. Great progress has been made in this field in recent years, both in agreeing on norms and implementing them. For instance, norms have been produced for payment systems, accounting and auditing, bankruptcy legislation, transparency in fiscal and monetary policy and measures against money laundering. When I was the Nordic-Baltic representative on the IMF's Executive Board, we worked hard to establish norms for correct and detailed reporting of economic statistics. The World Bank, the IMF and other organisations support countries wishing to adapt their legislation to meet the norms, by assisting with expert help. Several Swedish experts take part in this work.

It is in the interests of all nations to apply these jointly agreed norms, as this reduces the risk of financial crises. In addition, countries that do not follow the norms will find it more difficult to borrow on the international capital market, since lending is more risky. Access to capital will therefore be more restricted and interest rates will be higher.

It is also in the countries' own interests that other countries meet the norms, as financial crises in one country have a tendency to spread to other countries in similar circumstances. We saw an example of this during the Asian crisis 1997-98. As Sweden is a small country with an open economy and therefore dependent on financial stability in the world around us, we contribute experts to the groups working out the norms. Sweden also gives advice to countries wishing to improve their application of these norms. Riksbank employees have provided assistance in countries all over the world, including Latvia, Poland and Sri Lanka.

A good example of internationally agreed norms for increasing stability on the financial markets is the capital adequacy rules for banks that were developed by the Basel Committee. These rules came into force in 1988 and cover risks in for example lending, interest rate trading and foreign exchange trading. In principle, they require that the greater the risk taken by a bank, the more capital it must hold. As it costs money to hold capital, this creates an incentive for the banks to reduce their risk taking. The rules also increase the banks' opportunities to cover any losses they may incur. The current rules are applied in more than 120 countries. The proposal for new capital adequacy rules recently presented makes an even closer connection between the capital requirement and the risks taken, as well as reducing regulatory arbitrage and increasing the requirement for transparency.

While the Basel rules thus reduce excessive risk taking, they do not impair transactions made with the purpose of redistributing risks between banks, enabling a healthy level of risk taking to be attained within the respective institute. These transactions contribute to reducing the banks' risk taking and currently comprise a large part of the turnover on the foreign exchange market.

Allow me to give an example of how this works. A Swedish export company with income in dollars, but paying out wages and taxes in kronor, must exchange dollar income for kronor. The company transfers the foreign exchange risk to the bank, by selling dollars for kronor. This can be done in two ways: either the company sells the dollars when it receives them, on the spot market, or it sells its future dollar income as soon as it receives an order, on the forward market. In both cases the bank buys dollars and thus takes over the foreign exchange risk. The bank also makes a charge for doing this. Today the margins in foreign exchange trading are 0.02 per cent. The bank's foreign exchange risk thus increases, unless another client happens to make an equally large foreign exchange transaction in the opposite direction at exactly the same time, ensuring that the bank's holdings of various currencies remains unchanged. This is, of course, very unlikely. The export company's foreign exchange transaction therefore gives rise to several transactions between banks, with the aim of distributing the foreign exchange risk throughout the banking system. This means that the clients' purchases and sales of various currencies and in various banks are matched against one another, to avoid an increase in the total risk in the banking system. The first foreign exchange transaction will therefore lead to many new transactions before all of the banks have once again achieved a healthy level of risk taking.

The same applies to all types of foreign exchanges - for instance, when SIDA exchanges kronor for foreign currency to provide foreign aid, when the pension funds buy foreign shares, when we buy foreign insurance policies and when the mortgage institutes borrow abroad. I believe it is important to be aware of how the risk distribution between the banks functions. Transactions on the foreign exchange market do not need to be speculative at all, even if they do not have any *direct* link to payments for trade, investment or aid between countries. It is not possible to take the total of all cross-border payments for goods and services and say that all other foreign exchange deals are unnecessary.

Finally, allow me to comment on the proposal of a Tobin tax. Taxes on financial transactions have already been tested in a number of countries, including Sweden. At the end of the 1980s, we had a securities transaction tax here. The result was that the turnover declined severely. Trade in securities fell by around 80 per cent. Part of this trade was moved abroad and some ceased altogether. Nor did the securities transaction tax manage to prevent the 1990s crisis. A Tobin tax would be difficult to apply, as it assumes that all countries support it. This is unlikely, as the countries that did not apply the tax would benefit, in that a large part of financial activity would move there. And even if it were possible, I do not consider the Tobin tax to be a good method of reducing speculation and excessive risk taking on the financial markets. On the contrary, there could be an increase in risk taking when the possibilities for insuring oneself against financial fluctuations become too expensive and the banks' opportunities for distributing risks are reduced. Instead, I see the international work already being carried out into producing norms for various areas as a better means of promoting stability and reducing risks.

To summarise, the credit and foreign exchange markets play an important role in society by mediating payments and savings, both nationally and internationally. The best way to prevent excessive risk taking is not to tax transactions, but to ensure that more countries pursue fiscal and monetary policy aimed towards stability, with a suitable exchange rate regime, and follow the international regulations and norms that promote stability. These norms must be continuously adapted to developments on the financial markets and in the rest of the economy, in order to limit the risks in the financial sector.