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71st Annual General Meetin

Speech delivered by

Urban Bäckström

Chairman of the Board of Director

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Bank for International Settlements

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held in Basel on 11 June 2001

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Chairman of the Board of Directors

Ladies and Gentlemen,

On the occasion of the 71st Annual General Meeting of the Bank for International Settlements, it is my privilege and pleasure to extend a warm welcome to all the delegates from our shareholding central banks, the representatives of non-member central banks and international institutions and our distinguished guests.

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Before I turn to our traditional review of salient aspects of the Bank's affairs, I regret to have to inform you of the recent death of a former member of the Bank's Management. Maurice Toussaint died on 5 June 2001 at the age of 80; Mr Toussaint was a Manager of the Banking Department from 1971 until his retirement in 1986.

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I would like first to comment briefly on the financial results for the year ended 31 March 2001. The Balance Sheet and the Profit and Loss Account, duly audited, appear at the end of the Annual Report; a commentary on the Bank’s operations is provided in the chapter of the Annual Report entitled “Activities of the Bank”.

The Balance Sheet total increased by 1.6% during the year to 76.1 billion gold francs, which represents a record for the end of a financial year. The Profit and Loss Account shows a net profit of 271.7 million gold francs, a decrease of 11.7% compared with the figure for the previous financial year. This decline is principally attributable to losses incurred on the early repayment of certain of the Bank’s securitised liabilities. Since these losses will be recouped over the period to the original maturity of the claims concerned, the underlying economic profit situation of the Bank remained stable. The factors behind the decrease are described in more detail in “Activities of the Bank” under the heading “Net profits and their distribution”.

I am pleased to inform you that the Board of Directors recommends that the present General Meeting approve an increase in the dividend from 340 to 360 Swiss francs per share. The number of shares on which a dividend will be paid is 452,073, which excludes 77,052 shares held in treasury, comprising 72,648 shares formerly in private hands, 2,304 shares repurchased from central banks and 2,100 other shares. Accordingly, a sum of approximately 48.6 million gold francs, being the gold franc equivalent of the total dividend proposed, has been set aside for this purpose.

As for the remainder of the net profit, amounting to 223.1 million gold francs, it is proposed that the present General Meeting approve transfers of a sum of 44.6 million gold francs to the general reserve fund, a sum of 3 million gold francs to the special dividend reserve fund, and the balance of 175.5 million gold francs to the free reserve fund.

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Turning now to the administration of the Bank, the major event of the past financial year was the repurchase of privately held BIS shares.

In January 2001, an Extraordinary General Meeting decided to restrict the right to hold shares in the BIS exclusively to central banks, and accordingly approved a proposal of the Board of Directors to proceed with the mandatory repurchase of all shares held by private shareholders against payment of compensation of 16,000 Swiss francs for each share.

In order to effect this mandatory repurchase, Articles 6, 12 and 15 to 18 of the Bank's Statutes were amended and a transitional provision was included as Article 18(A) of the Statutes. These statutory amendments are based on the special international rules applicable to the BIS as an international organisation, including the Bank's Constituent Charter and its Statutes.

At end-May 2001, compensation payments had been released for 82,7% of the total of 72,648 shares which were formerly in private hands. 86,5% of private shareholder accounts had been closed at that time. The remaining former shareholders have been contacted again but have yet to reply to the Bank or to send all documentation required to process the compensation payments.

A small number of former private shareholders are contesting the amount of compensation to be paid and the valuation methods chosen and have filed complaints against the Bank either before the Arbitral Tribunal provided for by the Hague Agreement or in national courts. The BIS has requested that all such claims be referred to the Arbitral Tribunal in The Hague which, pursuant to Article 54 of the Statutes of the Bank, has sole jurisdiction to hear disputes arising from the transaction.

Among the Board of Directors, Hans Meyer and Gordon Thiessen retired from their positions as President of the Swiss National Bank and Governor of the Bank of Canada, respectively, and vacated their seats on the Board. The Board elected their successors at the respective institutions, Jean-Pierre Roth and David Dodge, as new members of the Board.

There were three changes among the Alternates of ex officio Directors. Antonio Fazio, Governor of the Bank of Italy, appointed Bruno Bianchi to succeed Carlo Santini; Guy Quaden, Governor of the National Bank of Belgium, nominated Peter Praet to replace Jean-Jacques Rey; and Ernst Welteke, President of the Deutsche Bundesbank, appointed Stefan Schönberg to succeed Helmut Schieber.

As regards senior officials of the Bank, Guy Noppen and Marten de Boer retired from their position as Manager at the end of September 2000 and the end of March 2001, respectively. Peter Dittus was appointed Deputy Secretary General from 1 October 2000. At the end of 2000, Josef Tošovský succeeded John Heimann as Chairman of the Financial Stability Institute.

Before concluding these remarks on the Bank's affairs, I wish to express my gratitude for the support offered to me by my colleagues on the Board and their Alternates in the past financial year. I also wish to thank the Management and staff of the Bank for their continuing contribution to the success of our institution.

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I would like to turn now to a review of global economic conditions. Let me look back on the main economic developments; look forward, as befits a good central banker, to identify potential risks; and finally stand back to reflect on some broader policy challenges concerning monetary and financial stability.

The salient economic development in the most recent period has been the deceleration in global growth. This started with an unexpectedly abrupt and sharp slowdown in the US economy in the later part of 2000, possibly heralding an end to, or a pause in, an extraordinary period of expansion. It was accompanied by a faltering of the recovery in Japan, and followed by a weakening of growth in emerging market countries and subsequently, to a lesser degree, in Europe.

By postwar standards, an unusual but welcome feature of the slowdown is that it was not fundamentally induced by tighter monetary policy aimed at quelling strong inflationary pressures. The tightening that did take place may have acted as a catalyst. But the slowdown seems to reflect a more spontaneous weakening in expenditures following the previous expansion and was heralded by sharply falling equity prices, rising credit spreads and tighter lending terms.

Indeed, globally, inflationary pressures have remained remarkably subdued at this point in the cycle, despite last year's rise in oil prices. This bears witness to the progress made in the long-standing fight against inflation. No doubt the wave of technological innovation has played a significant role here. But product, labour and financial market liberalisation, both within and across national borders, has been instrumental in bringing this outcome about. Moreover, the process has been underpinned by prudent fiscal and monetary policies in a growing number of countries.

We are already reaping the benefits of this success, in the form of greater room for manoeuvre. In response to the slowdown, monetary policies have, where appropriate, been eased. In some cases, where fiscal prudence has allowed more than the use of automatic stabilisers, this has also been accompanied by an actual or prospective relaxation of fiscal policy.

Since the slowdown started, the crucial question has been how long and deep it will prove to be. A deceleration in growth in the United States was expected and even desired, as it would allow the economy to avoid overheating and gradually to absorb the domestic and external imbalances built up during the previous rapid expansion. Of these, the negative private saving rate and the large current account deficit have attracted most attention. If the process went too far, however, it could have significant implications for a world economy that, as I will explain in a moment, still exhibits a number of weak spots.

By mid-May, the upturn in equity prices, narrowing credit spreads, a firm dollar and the shape of the yield curve were all signs that financial markets were anticipating a relatively quick recovery. Official forecasts have been suggesting a broadly similar central scenario.

A number of factors could give grounds for optimism. In the United States, there have been clear signs that the inventory cycle has largely run its course and that consumer confidence has been holding up. The new government in Japan has indicated a fresh determination to implement the long-awaited financial and corporate restructuring. Borrowing in international securities markets was particularly buoyant in the first quarter of 2001. The financial crises in Argentina and Turkey have seen only limited contagion so far. And the room for some central banks to ease policy further as long as inflationary pressures remain subdued can provide some comfort.

Even so, we should be mindful of the risks ahead. The road leading to the hoped-for sustainable growth is a narrow one. The real and financial imbalances built up during the long expansion might not unwind as smoothly as might be expected. There is a tension between short-run and long-run dynamics.

One example of this tension is how the external imbalance in the United States might be resolved. Paradoxically, if the central scenario actually materialised, it would do little to address this imbalance. Doing so would most likely need to be accompanied by an effective depreciation of the dollar. The question is whether such an overall adjustment would take place smoothly and without rekindling inflationary pressures in the United States and unwelcome deflationary forces elsewhere.

Another example of the tension has to do with the nexus between investment and consumption at the current juncture. The key to further expansion in the United States, and to a lasting recovery in Japan, is maintaining and restoring profitability, respectively. This would help to propel investment, bruised by an overhang in the capital stock. But in the short run, sustaining profitability could risk setting in motion forces that might depress consumer expenditure excessively. In the United States, if underlying productivity growth is indeed permanently higher, the current slowdown will entail sizeable job losses, at a time when the household savings ratio is at an all-time low and indebtedness relatively high. Sizeable job losses would also need to accompany the restructuring in Japan. In both cases, the resilience of the consumer might be severely tested.

How the future unfolds will also depend on developments in the financial sector. The link between the slowdown in profits, asset prices, financial conditions and the real economy is critical. Here again the picture is mixed.

There are clearly some very encouraging signs. In contrast to previous episodes, such as October 1987, equity prices have undergone a major correction without so far causing obvious strains in the markets. Signs of exuberance in property prices seem so far to be limited to a few countries. With the exception of Japan, the banking sector generally appears to be in better shape than before previous downturns. Encouraged by supervisors and scarred by previous experience, financial institutions have tightened risk management practices. And emerging market countries have taken steps to address the vulnerabilities revealed by the Asian crisis, especially with regard to their external debts.

Nevertheless, weak spots remain. Since earnings have fallen sharply, equity markets still look high by historical standards. The rapid growth of credit in several countries during the upswing has led to a substantial accumulation of leverage, not least in the telecoms sector, while bank provisions are, as always, comparatively low at this point in the cycle. In Asia, particularly exposed to the slowdown in the IT sector, financial restructuring has not proceeded as speedily as might have been warranted. Large external deficits make Latin America and eastern Europe vulnerable to a sudden change in market sentiment. And the resilience of new instruments, such as credit derivatives, as well as that of markets and intermediaries, recently subject to considerable structural change, has not yet been fully tested.

It is, of course, natural for risks and uncertainties to loom large at turning points in economic activity. Upon reflection, however, the character of the risks at the current juncture is rather novel in the postwar context. As such, it also contains clues about the evolving nexus between monetary stability, financial stability and the business cycle. Allow me to make four observations and to outline two broad policy challenges.

First: financial liberalisation has resulted in a much tighter link between financial and real economic developments. This has greatly improved the allocation of resources and underpinned the higher growth potential of the world economy. At the same time, it may also have contributed to amplifying business cycle fluctuations. Access to external finance is more plentiful and more intimately driven by perceptions of, and appetite for, risk. And these move strongly with economic activity. Hence the highly procyclical nature of credit, asset prices and market indicators of risk, such as credit spreads.

Second: much of the financial instability experienced since at least the late 1980s in industrial and emerging market countries reflects instances in which the above mutually reinforcing processes have gone too far. In too many countries, financial imbalances, and the associated distortions in the real economy, grew in the expansionary phase and their subsequent unwinding overwhelmed the often weak lines of defence in place. The costs in terms of GDP forgone have been high. It seems that we are all better at judging the relative risk of different instruments, institutions and counterparties than at assessing how risk, especially system-wide risk, evolves over time.

Third: many of these episodes of instability have taken place against a benign inflation background. Low inflation is necessary for sustainable long-run growth but is not sufficient to prevent financial instability. In fact, low inflation can sometimes allow the build-up of underlying imbalances to proceed further. It can do so by encouraging optimism about the future and obviating the need for monetary tightening to contain rising prices.

Fourth: as a result of the present configuration of arrangements in the monetary and financial spheres, the current business cycles may arguably have come to resemble more closely those under the gold standard. For it was then that a liberalised financial environment last coexisted with a monetary regime that enjoyed high anti-inflation credibility. There are two key differences, however, that may have the potential for amplifying fluctuations in our modern times, by making the present system more “elastic”. One is the presence of safety nets in the financial sphere; if ill-designed, they can encourage excessive risk-taking. The other is the absence of an external constraint on credit expansion in the monetary sphere, such as convertibility into gold. The issue is how far these two differences are offset by the prudential regulatory and supervisory framework now in place and by the discretionary response of the monetary authorities to economic developments.

I suspect that in the years ahead we will be devoting increasing attention to these complex issues. The policy goal, as always, should be to put in place safeguards in the financial and monetary spheres to reap the long-run benefits of a liberalised environment while limiting financial instability and its attendant costs. This in turn implies two key challenges, elaborated further in the body of this year’s Annual Report.

The first challenge is to strengthen the lines of defence in the prudential area. We have done a lot in recent years, with respect to institutions, markets and infrastructure. The proposed revision of the Basel Capital Accord is just the latest, highly welcome example. But more can be done to build on this solid base. A guiding principle is to strengthen further the system-wide orientation of the prudential framework, with respect to both diagnosis and cure. Salient examples include improving the design of safety nets and studying possible ways of limiting the amplitude of financial cycles and their consequences.

The second challenge is to assess critically the relationship between monetary policy and financial stability with a view to consolidating the gains on the inflation front without unwittingly incurring costs. The issue is whether there are conditions under which it might be appropriate for monetary policy to respond to the build-up of financial imbalances and, if so, how this could be done.

I am fully aware that these are difficult, indeed uncomfortable, questions. Yet tackling them may hold one key to further progress in our search for enduring monetary and financial stability. Doing so will call for close dialogue and cooperation between monetary and prudential authorities. The BIS and the Basel-based community more generally will no doubt continue to play a prominent role in this endeavour.