Speech

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Financial markets in a globalised world

The Swedish Mutual Fund Association

I should like to begin by thanking you for the opportunity to participate in your conference on mutual fund investments in Europe. Mutual fund investment is now a very important part of the financial system, both at a national level and at a global level. I therefore intend to take this chance to discuss the significance of the financial system for economic development, using mutual fund investment as a basis, and to take up some of the problems connected with the way the system functions.

Rapid transformation of the financial system

Over the past few decades the financial system has been fundamentally transformed. Deregulation and technological achievements have made the Swedish financial sector part of a global network where the sun never sets. Those of us who work in this sector cannot have a limited local, or even regional, perspective. We have had to learn to live with the fact that events in countries such as Indonesia and Thailand can have a direct bearing on our operations. This is of course exciting, although it also makes our work more complicated. But that is the consequence of living in a globalised world.

Swedish savers have adapted to this development on a large scale. Whereas it was once natural to put money into a normal savings account, this is no longer the case. Today, an increasingly large share of savings is being invested in various securities and the rapid expansion in the mutual fund market is an important part of this development. One only needs to look at the Swedish Mutual Fund Association's

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own report on mutual fund investment in Sweden to realise this. The statistics show that new mutual fund investment has increased gradually during the 1990s. In 1994 net investment in mutual funds totalled SEK 7.5 billion. Last year the corresponding figure was SEK 99.1 billion. This is an entirely natural development, as it has been possible to obtain a significantly higher yield from savings invested in various types of securities than from savings paid into a traditional savings account. Swedish investors have not only realised this, they have also understood how to use the financial market to spread their risk by investing money both in fixed income funds and in shares in different types of companies within different sectors and countries.

Many people, including me, see this development as a positive thing; others are critical and express concern over what they call an insensitive fund capital, shovelling money around the world and quickly withdrawing from countries that show the slightest sign of problems. This criticism cannot be completely dismissed, but I do feel that it often does not fully take account of the importance of the financial sector for economic development. In addition, the critics often speak of this sector as though it did not play any productive role, but was more or less disengaged from the rest of society. This is not the case. The financial sector is very much an integrated part of society. We participate in it ourselves when we, for instance, choose between different pension funds, when we withdraw money from an ATM, when we pay our bills or borrow money to buy a house or apartment. To begin with, therefore, I shall briefly discuss the fundamental tasks carried out by the financial sector in society. When we economists try to mediate knowledge in this field, we usually talk about three tasks or roles, namely mediating payments, channelling money from those wanting to save to those wanting to invest, and facilitating the management of economic risk.

Easier payments and more investments

The financial sector as a mediator of payments is possibly the role where the sector's significance for society is easiest to understand. Try to imagine an economy without the type of payment system offered by, for instance, postal giro and bank giro. In a world like that we would need to carry large amounts of cash around with us in order to make our daily transactions. We would have to rush off to the landlord once a month to pay rent, visit the telephone company to settle the telephone bill and queue in front of the TV building to pay our TV licence. Thanks to various payment systems, we can avoid this inconvenience. This not only has a value in making our everyday life easier; there is also a large economic value, as we are able to use our time for other things rather than queuing to pay bills. The Government Inquiry on the future of the financial sector presented last year estimated the value of this at more than 7 per cent of GDP, which corresponds to approximately SEK 150 billion. This indicates the importance of properly functioning, stable payment systems.

Mutual fund investment plays an important part in the financial system's other role. This concerns converting savings into investments. Without financial markets each investment would have to be financed by the actual investor, whether it was a question of buying a house or starting up a company. The financial markets' economic contribution here is that they make it possible to distinguish between the decision to save and to invest, so that the investor does not need to save all the necessary money before making the investment. This enables the implementation of many projects that would not otherwise see the light of day. However, the financial sector does not merely make it possible to distinguish between these decisions; it also makes it possible to solve the conflict of interests that often prevails between the saver and the investor. A saver often wants to be able to get his money back quickly if the need arises. An investor, on the other hand, normally needs to have the money over a longer period of time, as it usually takes a while before an investment pays off. The financial sector offers two possible solutions to this conflict of interests. The investor can either turn to a bank, which can convert savings into long-term lending, or the investor can issue securities directly onto the market. In both cases, the saver can normally regain his money at relatively short notice. In the first case, the money is withdrawn from the bank and this works painlessly, unless all the other savers have the same idea at the same time. In the second case, the securities are sold on a secondary market. Without these possibilities to quickly realise savings, there would be much less money channelled into investments, which are of crucial importance for economic development. A properly functioning capital allocation is thus of major importance to a country's long-term growth, which is also confirmed by several empirical studies made in this field. Mohsin Khan and Abdelhak Senhadji have made a review of such studies for the IMF. I can recommend it for those who are interested.

Facilitating risk management
Then we come to the third fundamental task of the financial sector; facilitating the management of economic risks. As I mentioned earlier, Swedish savers have already realised the importance of not investing all their savings in the same place. When one distributes one's savings across a number of funds with different allocation, for instance to various industrial sectors, there is less risk, as one would not suffer such great losses if one fund were to show a poor development. However, the financial markets also offer other opportunities for risk management. It is possible to pay someone else to take over a financial risk. This can be done with the aid of various types of derivative. For example, in export deals it is not unusual for payments to be made some time after the goods have been delivered. To avoid negative effects of a change in the exchange rate, the exporter can enter into a futures contract that establishes the rate at which the future income will be exchanged to the exporter's own currency. These opportunities for risk management have crucial economic importance. Without them, many economic projects would be perceived as too risky and would never be realised. And this would lead to a slower development of the economy.

Deregulation and the rapid developments in technology and finance have made it possible to transfer these roles to the international stage on a much larger scale than before. Thus, the financial markets' capacity to contribute to increased global growth has been strengthened. Countries importing capital can increase their rate of investment and gain access to more modern technology, while the countries exporting capital can obtain a higher yield on it. Many people have claimed in this context that companies in countries, which have recently deregulated their capital markets, have a tendency to take on more loans than they can manage. This does not appear to be the case. On the contrary, empirical research indicates that while non-financial companies with access to the international capital market increase their borrowing, their equity increases at the same rate. It also appears that these companies increase the duration of their loans. In this perspective, it is difficult to imagine that the risk of taking out excessively large loans increases as a result of deregulation. The various types of funds managed by many of you make a contribution to this, by supplying share capital to companies in other countries.

Economic policy content of crucial significance

Allow me to return to the criticism of developments on the financial markets. As I said, it cannot be dismissed out of hand. It is evident that there are some problems in the way these markets function. One only has to look at the Mexico crisis of 1995 and the Asia crisis of 1997-98 to see that. It is, however, important to remember that the origins of the crises lay in domestic problems in those countries that were hardest hit. In Asia, as was the case here in Sweden at the end of the 1980s, the countries developed a financial vulnerability through rapid credit expansion, over-investment in certain sectors, grossly inflated asset prices and short-term borrowing abroad. This borrowing was in turn channelled via domestic banks into projects with long-term funding. When foreign and domestic investors began to show concern over uncertainty regarding the growth potential of these countries, the course of events moved rapidly. This development shows how a misdirected economic policy can soon have devastating consequences for a country. However, instead of focussing on the content of the economic policy, many critics have singled out the open capital markets as culprits. Some of these critics have therefore considered capital controls to be a good means of avoiding future crises. Yet the experiences of the 1970s and 1980s show that these controls cannot counteract the effect of an inadequate domestic economic policy in the long term. Sooner or later it will be necessary to adapt the exchange rate. It is also very doubtful whether capital controls have contributed to increasing monetary policy independence during these decades, which was one argument put forward in favour of the controls. In practice, it was probably the case that the arguments for keeping the controls were often used to postpone necessary macroeconomic adaptations and structural reforms.

Nevertheless, while financial deregulation creates opportunities for increased welfare, it is important not to ignore the problems in the financial system. Over the years, authorities and organisations have tried to minimise these by producing various international standards and codes, and have continued to debate what more needs to be done to prevent as far as possible the emergence and spread of any new financial crises. I shall not go into this work in any great depth here. Instead, I will discuss some factors that could contribute to strengthening movements on the financial markets in an unhealthy manner, and where we need to find other solutions to improve the functioning of the markets. These factors can also be more directly connected with mutual fund investment.

Short-term evaluation and 'follow the leader' behaviour

The first thing that comes to mind here is the way many of the operations on the financial markets are evaluated. All too often the focus is on the short-term result.

This applies in particular to the evaluation of various securities funds. Although many of you manage long-term savings that people intend to live on after retirement, you are nevertheless evaluated on the results you have achieved over the past year, the past few months or even the past few days. We have all seen the newspaper headlines declaring the winners and losers in mutual fund investment. Media coverage of developments on the financial markets certainly plays an important role for the transparency of these markets, but the focus on short-term results can create a vicious circle where investors and companies are constantly chasing the best possible result in the short term, despite the fact that this is not a good long-term strategy. Such behaviour can reinforce financial crises; for instance, through a fund manager not being given scope to wait until the crisis has abated, which could be rational in a long-term perspective.

Many players in the financial markets also appear to be governed by a 'follow the leader' principle. There are probably some who avoid going their own way because of the risk of making bad investments and being depicted as losers. It then seems simpler to follow the others, as if things do go wrong, at least the player is not the only one in disgrace. The reward structure in the fund management field probably also reinforces this behaviour. As long as a person has not done a worse job than the average among the competitors, he can look forward to a bonus. It would probably be a better idea if the personal income were more closely connected to the absolute result achieved by the fund.

However, the desire to follow others is probably also an expression of uncertainty. The players have too little information to really dare to act independently. It is doubtless the case that players in the financial markets, including the mutual fund investment companies, live in a complicated world. In this world it can be rational to do as the larger players do in the hope that they are better informed. However, this is not always the case, which means that the strategy of following the big players could contribute to worsening financial crises. When everyone rushes for the door at the same time, there is often a crush. And in a crush, it is easy to panic.

The broad use of statistical risk models can have a similar effect. It is, of course, a good thing to use risk models as an aid and we can conclude that they have enabled great progress in the management of financial risks. However, there is an evident problem here. When an increasing number of players are using the same models, they are also likely to react in a similar way when there is unease on the markets, which can reinforce fluctuations and trigger new signals from the models, and so on. What is rational for one individual institute may in this case be irrational as a whole.

Increased transparency reduces risk of herd behaviour

So is it possible to counteract this type of behaviour? Allow me to begin by emphasising that economic risk-taking in itself is an important factor behind economic growth. However, risk-taking also means that not all investments will bear fruit. This is why we have created national bankruptcy regulations enabling businesses to be liquidated in an orderly manner. For the same reason, we must assume that financial crises will emerge even in the future. On the other hand, we must of course do all we can to avoid such crises spreading unnecessarily. I should also like to stress that I do not believe that different types of taxes aimed at reducing the turnover on the markets are a practicable route forward. They would probably result in further reinforcement of fluctuations, as activity - and thus liquidity - on the markets would decline. As representative of a central bank, I would also like to point out that nor do I believe that monetary policy alone can counteract exaggerated movements on the financial markets. On the other hand, a clear monetary policy, aimed at price stability, is necessary in the work on maintaining financial stability. It facilitates economic decision-making in society.

However, part of the solution must lie in breaking the pattern that causes players to behave in exactly the same way as one another. Increased transparency with regard to countries' and companies' economic status is an important step in the right direction here. Developments in technology have demolished many of the barriers that previously hampered the spread of this type of information. However, this requires that authorities and companies make use of the opportunity and actually release important information. We at the Riksbank, like many other Swedish authorities, have for quite some time now made use of the advantages of the Internet in this context. All important information is published on our website, which is easily accessible to most people. This applies regardless of whether one is an analyst at a major bank or whether one is a private person. Information technology has thus created a powerful instrument, which can be used to counteract the 'follow the leader' behaviour. When information is no longer exclusive, it becomes easier to form an opinion of one's own with regard to developments and risks, and not merely to follow others in the belief that they know something you don't. At the same time, it is important to remember that our insight into why financial crises arise and spread is still limited. This means that increased transparency will not in itself be able to solve all of the problems discussed. It must be combined with increased knowledge of these issues.

Cautious use of risk models

The financial crises have exposed the failings in the various statistical risk models regularly used by players on the financial markets. These are nothing more than very simplified pictures of reality and are based on historical values. And history doesn't always constitute a good base for making forecasts for the future. Financial players must therefore become better at taking into account less probable events when they are analysing the risks of various investments. One example of how this could be done is to supplement the risk models with "stress tests". These tests are used to analyse how "stressed markets" - i.e. exceptional, but possible, outcomes or events - would affect the players' current positions. According to the latest quarterly report from BIS, use of stress tests is becoming more widespread and many financial institutes now use them as an integrated part of their risk management. Increasingly often, decisions on how to react when various risk limits are exceeded are being taken on the merits of the individual case, rather than being based on a mechanical rule.

Greater transparency and less mechanical use of risk models could be contributing factors in improving the functioning of the financial markets, but they will not solve the problem of short-term assessments of financial operations. Counteracting this requires clear information on the targets for the financial operations. This is an important task for the authorities, the individual companies and various types of business association, such as the Swedish Mutual Fund Association. In connection with this, it is of course necessary to review the advice provided to clients. And, as I mentioned earlier, I also believe that a review of the reward structure in the mutual fund business would be useful, so that incentives for fund managers are better adapted to the interests of the savers.

Conclusion

The rapid economic internationalisation has made daily life much more complicated for many of us who work in the financial sector. Today, for instance, a person managing various securities funds in principle has the whole world on his or her desk. It is not enough to have good knowledge of a particular type of company or sector, or of developments in an individual country. What is required is a constant monitoring of the economic system, how its various parts are integrated and what possible risks there are that problems in one sector or country will spread to other sectors or countries.

On a more comprehensive level, it can also be concluded that the internationalisation of recent decades has given the financial markets greater opportunity to contribute to global economic development. Savings can now be channelled with relative ease into the sectors and countries where they will be of most use, while financial innovations facilitate risk management in economic life. Together, these advances have meant that more investments could get off the ground and improve the welfare of millions of people in both rich and poor countries.

At the same time, the strength of the recurring international financial crises has shown that these markets do not always function entirely without problems. At times, there has also been considerable criticism of the players on the international financial arena. Although this may sometimes be warranted, unfortunately it all too often stems from the opinion that financial operations are a bad thing. I have therefore tried to describe today the tasks carried out by the financial system in society. These not only make our daily life easier, but also provide a crucial contribution to economic development. It is therefore important that our solutions to the problems we see in the financial system do not destroy these welfare-creating mechanisms, but instead contribute to reinforcing them. For the same reason, it is important that countries pursue a good domestic economic policy. Sound government finances and sustainable price stability, combined with structural reforms that increase the flexibility of the economy, will reduce fluctuations in exchange rates and capital flows and thus increase the financial markets' capacity to contribute to the development of the economy.

Thank you.