Speech

Deputy Governor of the Riksbank Villy Bergström

MONDAY 11 FEBRUARY 2002

Does globalisation have anything to do with the closing down of the ATM?

Grycksbo - pappers avd 111

Globalisation is an unclear concept and I think that the chairman of Pappers avdelning 111, Lars Göran Johansson, who invited me to this meeting, gave me an interesting task when he formulated the heading for my talk. He phrased it as a question; "Does globalisation have anything to do with the closing down of the ATM?".

I shall return to what I believe that people in general mean by globalisation and I shall also return to Lars Göran's question at the end, but allow me to begin by saying that Sweden has undergone a globalisation process for more than 100 years, in the sense that our country has been exposed to competition. A large proportion of our total production has been aimed for a long time towards the export market, while we have imported goods and received foreign investment capital.

Foreign trade comprised approximately 20 per cent of the Swedish economy from the 1870s until the end of World War II. That is to say, import and export each comprised 20 per cent of the total production here in Sweden. An increase in foreign trade began during the post-war period, and export and import now comprise approximately 40 per cent each of our total production. This means that Sweden has a very open economy, exposed to competition on the world market.

In a way, the globalisation process at the end of the 19th century went further than the process we are seeing now. This was because the labour force was more

Telefon 08-787 00 00
Telefax 08 - 21 05 31
E-post registratorn@riksbank.se

mobile across national boundaries then. Prior to the World War I, there was extensive emigration, primarily to the American continent. Sweden lost one quarter of its population through emigration. Between 1890 and 1910, 10 per cent of the world's population moved permanently from one country to another. During the past quarter of a century the corresponding figure for emigration was only 1-2 per cent.

I think that what one usually means by globalisation is that which has happened on the capital markets over the past 20 years and which is connected to the deregulation of capital markets. For Sweden, this goes back to the mid-1980s, when deregulation of the capital markets began. The deregulation process reached a peak when the final elements of the currency regulations were abolished in 1989, enabling the free movement of capital across our borders.

However, this is nothing new, either. Prior to 1914 capital could move freely over national borders. There was extensive direct cross-border investment. This was when the Swedish railway network was built up and the Swedish hydroelectric power system was built with the aid of foreign capital. However, I think that the deregulation of the capital markets was still seen as something new and that it is the political change during the post-was period that has mainly changed the conditions for economic policy. What people perceive as "globalisation" is probably exactly that, combined with the fact that the new information technology enables all transactions to be implemented much more quickly than before. However, the concept of globalisation also includes the growth of multinational companies, with production units in different countries, the fact that an increasing number of countries are drawn into the international trade exchange and that the labour force moves freely between countries, which is the case at least within the EU.

When currency regulation was abolished, foreign investors could begin to buy Swedish treasury bonds and shares. Swedes could also begin to save in foreign banks, pension insurance funds and shares. There had existed major obstacles to such transactions before, although they were not completely impossible to overcome.

Foreign ownership of Swedish shares and SEK-denominated bonds rose from almost zero in 1980 to SEK 1,350 billion in 2001. When the barriers for capital movement were removed in this way, Sweden became subject to daily examination. The slightest sign of mismanagement of economic policy, such as a growing budget deficit, rising payroll expenses or inflationary tendencies risks leading to foreign investors selling off their holdings of Swedish treasury bonds and shares. Signs of mismanagement can also lead to Swedish households and companies choosing to invest their money abroad. This was the mechanism that made it impossible for us to keep the fixed exchange rate regime in 1992. At the time of the deregulation, Sweden had a history of high inflation and other imbalances. Doubts regarding the stability of the Swedish economy led to capital outflows, rising interest rates and a shrinking foreign currency reserve. Despite massive supporting purchases of the Swedish krona and a drastic defence involving a 500 per cent daily lending rate for banks borrowing from the Riksbank, the defence of the exchange rate failed. This meant that the general public had to live for a period with a 25 per cent interest rate for long-term mortgages!

Lottery with a good chance of winning

Financial capital is very transient, if not "restless". It is difficult to obtain good statistics on capital flows, but I have managed to find the following observations. Cross-border trade in shares and bonds in the USA more than doubled as a percentage of the US GDP between 1970 and 1993. During the same period, the corresponding volume rose from almost zero to 10 times GDP in the UK.

A fixed exchange rate offers speculation at no risk, if there are signs that the currency is over-valued. This was the situation in Sweden in the early 1990s. The fixed exchange rate regimes signalled to speculators that the exchange rate could only weaken. Either the fixed exchange rate would hold firm and then investors in Swedish kronor would break even, or else the central bank would devaluate. An investor who, for instance, borrowed Swedish kronor and used them to buy dollars, would then, following a devaluation, have a debt in devaluated kronor and assets in dollars. The actual speculation is aimed at causing a devaluation that will lead to this type of profit. However, what encourages speculators to act in this way is an economy that is out of balance, e.g. with a large central government debt, poor public finances or poor competitiveness as a result of high costs.

There is a long list of examples, where speculation has made it impossible to retain a fixed exchange rate. As I said, Sweden was forced to abandon its defence of the krona in 1992; the ERM co-operation within the EU with a narrow band for fluctuation broke down in August 1993; Mexico was affected in 1994-95, South East Asia in 1997, Russia in 1998, Brazil in 1999, Turkey in 2001 and Argentina this year. All of these crises have at least one thing in common: the countries concerned had a fixed exchange rate.

There are both technical and economic reasons for the large deregulation that occurred in Sweden and other countries. For instance, the advent of the new technology – IT, electronic money and new financial instruments – made it more difficult to retain currency regulations and capital market regulations. The "leaks" became increasingly large. Another thing was that economic policy had reached the end of the road, inflation was clinging tightly to an annual level of 8-10 per cent in Sweden, growth was poor and unemployment was showing a tendency to rise.

When the deregulation of the financial markets got off the ground in Sweden, the process was rapid – in 25 years we had moved over from being one of the most regulated financial systems in the western world to being one of the most free! However, the process was not exactly painless. The consequences of the macroeconomic imbalances built up during the period of regulation, combined with the Swedish banking system's incapacity to manage risk in its lending when credit granting was deregulated were dramatic, to say the least. We experienced this at the beginning of the 1990s, after the bank crisis and after abandoning the fixed exchange rate regime.

During the difficult years at the beginning of the 1990s, with what was for Sweden record-high unemployment, a risk of the central government debt running riot and stubbornly high inflation expectations, despite a low inflation rate, there were not many people who dared to hope for such a rapid positive development as that we saw during the second half of the 1990s. The central government finances are now in good condition, the current account has showed a surplus for several years now, inflation expectations are at a stable level of 2 per cent and unemployment is down to around 4 per cent.

Crisis management instead of screening

Allow me to remind you of the crises we have had due to lack of competitiveness and that Sweden is an economy open to trading. During the 1970s Sweden suffered crises in the iron and steel industry, and in the pulp and paper industry. The Swedish shipyard industry met its end. Problems arose due to high Swedish payroll expenses and the fact that new producers from countries with lower costs entered the market.

How did we react to these crises? Extensive rationalisation programmes were implemented, production was made more efficient and companies were closed down. Today, Sweden has one of the world's most efficient steel industries. It is the same with the forest industry. Sweden did not choose screening and tariff protection for the bleeding industries; we chose to become more efficient through restructuring and retaining our openness.

Sweden handled the problems arising when the currency was over-valued in around 1990 in a similar way, which led to failing confidence in the fixed exchange rate regime. Our country ended up with a currency crisis that triggered a property crisis and a crisis in the banking system. The political parties put their differences to one side and worked together on consolidating the banks and then the central government finances. We chose not to reregulate the capital market, but to retain openness, as in the crisis of the 1970s.

The management of the financial crisis at the beginning of the 1990s has led to the Swedish banking system appearing to be better-equipped than those in many other countries. After the economic downturn and the tragic events in the USA last year, it is easy to forget that the Swedish economy is basically sound and therefore has good potential to meet new challenges. The deregulation processes have contributed to the discipline that now makes us stronger than many other countries in the EU and means that we have the possibility to come out of the current downturn in the global economy relatively easily. Unlike many other European countries, Sweden's public finances are in good condition, enabling the use of budget policy to subdue the downturn in economic activity.

Both with regard to free trade and deregulation on the capital markets, Sweden chose to take large costs to society in the form of production losses and mass unemployment in order to achieve a development that would be good in the long term. We have been able to reap the benefits of this since 1996, with growth rates in excess of 3 per cent a year up to the present economic slowdown. And so far, we have got off much more lightly than other countries.

The financial markets are important

A financial sector that functions efficiently is an important part of a country's economic infrastructure - just as important as the transport and energy systems. If the financial sector ceases to mediate payments efficiently, it could have very serious consequences for economic development. One of the Riksbank's tasks as established by law is to promote a safe and efficient payments system.

It is not as easy to see the direct usefulness of the modern financial system as it is to realise the importance of energy and transport. However, the functions of the financial markets - financing, risk management and mediation of payments - are as necessary in an advanced industrial and services society as the supply of energy and a functioning transport system.

In advanced societies, savings are at least partly separate from investment activities. The financial sector has the important task of balancing savers' need of security and liquidity against investors' need of long-term financing. It often takes a long time from investment until production results come onto the market. Households that save money could suddenly find themselves in need of access to their money, which is made possible by selling their savings in the form of, e.g. shares and bonds on secondary markets for these securities. A company like Stora Enso wants long-term financing for a new paper machine, which it might not be possible to sell in a couple of years' time should the company be forced out of the investment. The company's issues of shares and/or bonds provide this long-term investment, partly because the securities can be sold on a market without having to be redeemed by the company issuing them.

Another important task for the financial system is to reduce risks for both savers and investors. The fact that some companies can involve greater risk than others can be balanced in a well-differentiated financial market by savers spreading their savings across different forms, buying different shares, bonds, shares in mutual funds that in themselves represent a risk spread, and by depositing some in banks.

A company that takes on debt in order to make profits in future through sales on foreign markets can protect itself against exchange rate fluctuations by signing futures contracts, which state when and at what prices future income will be converted to kronor. The company can also buy input goods, such as oil, and sell, for instance, pulp at a forward rate, so that the company knows for certain what its future costs and income will be. It costs to do this, but the company then faces no risks. It is quite simply a form of insurance.

When it comes to smaller companies and individual households, the securities market is hardly a suitable alternative. The risks for operators on the capital market are difficult to assess and the costs of the transactions have to be spread out over large amounts. Instead, banks and insurance companies supply services to small companies and households. The banks act as intermediaries, who receive deposits that are liquid and convert them into long-term lending, so that savers' requirements can be reconciled with the needs of the investing company.

The mediation of payments is perhaps the most difficult to understand function of the financial market. But bear in mind that less than 10 per cent of all payments in Sweden are made with banknotes and coins. The remainder are through giro payments in various systems for small, mass transactions and large payments between banks and companies. If we were forced to use banknotes and coins, it would require a huge transport apparatus and considerable productive time to implement payments. New technology in this field is being developed all the time.

Just consider charge cards and e-money, where payments is through book-keeping in different accounts, without any physical money being in circulation. Millions of transactions of this type are made every day within Sweden and across our borders.

Globalisation, the freedom to make financial transactions across national borders, creates conditions enabling the financial systems to become more efficient in all of their functions. The possibility to find high yield investments increases, the possibility to spread risks increases and a large market also increases liquidity. When the financing costs become lower, there will be more investors all around the world, while savers will be able to obtain greater return for a given risk.

It is for these reasons that the PPM (Premium Pension Authority) and the AP funds (National Pension Funds) invest a large part of our pension money abroad. Because the Swedish institutions managing pension funds are now able to invest money in foreign shares and bonds, there is less risk for our future pensions. We will become less dependent on Sweden as a nation being economically successful as some of our pension money is invested in other countries' shares and bonds. However, it also makes us owners of very mobile capital, which immediately flees a country facing economic difficulty. None of us would want the AP funds or PPM to invest their capital in Argentina, would we?

Are poor countries negatively affected by globalisation?

Globalisation with regard to movement of free capital must be regarded as different when it comes to less developed economies. The population in these countries, e.g. in South East Asia, is more vulnerable than others in well-developed welfare societies.

Let us finally look at the events in South East Asia around 1997. Domestic banks lent money to long-term projects, often with government guarantees, such as shopping centres, hotel complexes, airports, motorways, etc. Banks and companies financed themselves by taking up short-term loans in the international capital markets, which had lower interest rates than the domestic markets.

When the foreign investors became nervous at the possibility that those making the investments might not manage to pay the interest rates, they cancelled the short-term loans, the capital flowed out of the country and the banks suffered a crisis. No interest rate was high enough to attract the foreign investors to provide new loans. The foreign currency reserves dried up and exchange rates came under pressure. Devaluation was the only way out. Bankruptcies, bank crises and mass unemployment were the result.

The large majority of citizens, who had nothing to do with the errors leading up to the crisis, were made destitute because their small incomes and savings declined in value. Large parts of the growing middle class in the worst hit countries in South East Asia were wiped out. Conditional support was often provided with tough requirements of economic policy restraint. A tight fiscal policy would create scope for financing restructuring in the banking sector. Stringent monetary policy would counteract an overly severe depreciation of the currency. This can be criticised with hindsight, as in South East Asia the countries often did not have problematic deficits in public finances or high inflation rates. The IMF has admitted since that the restraint was too great, as they did not realise the extent of the financial crisis.

The task for the BIS, the IMF, the World Bank and other international organisations should be to continue the work on finding rules and methods, both to protect innocent people from ruination and to put the risk for bad investments on those making the investments. Work on this is underway in the organisations I mentioned earlier. It involves capital adequacy rules for banks, but also reporting, auditing, financial supervision, bankruptcy legislation and transparency in conducting monetary and fiscal policy. The purpose of this is that those who have lent money will be forced to a greater extent than they are now to bear the costs of solving a crisis, in order to encourage them to show greater caution when making investment decisions. However, it is also important that the organisations mentioned counteract corruption and work actively to achieve an open democratic culture in the new countries taking part in the globalisation process.

The recent globalisation debate has focused on a completely different issue, namely injustices in the distribution of income around the world and many believe that these injustices would be reduced if financial operators were prevented from rapidly moving money to where it provides the highest return. Many people feel that multinational corporations all too casually move their production to the countries that can offer the lowest production costs and this has also come up for debate in Sweden, particularly when Swedish regions have been hard hit by factory closures. The problems mainly concern the trade exchange between rich and poor countries and direct investment by rich countries in poor countries. Swedish history can also provide an illustration here. It has been calculated that the Swedish productive capital stock was 50 per cent higher during 1870 and 1914, through the import of foreign capital, than it would have been without this capital import. Sweden's industrialisation was thereby speeded up and welfare increased.

A market economy is the form of economic activity that has proved superior to all other alternatives, such as a planned economy, in almost all situations. When it comes to small, less well-developed countries, it has often been shown that the countries that opened themselves up to competition, imports and exports have developed much better than the countries that tried import substitution, i.e. tried to build up industries for all their own needs. Economic research indicates that this is the case. South Korea, Singapore and now China are examples of more or less open economies that are seeing much better growth now, while India had poor growth for a long time, as it closed its borders. Other countries that have closed themselves in, such as Nigeria, Ukraine and Pakistan, are suffering degrading poverty. Countries that were previously more open with a high standard of living can sink into crises and misery, as is the case with Argentina and Uruguay.

Participating in international exchanges provides investment, access to new technology and spreads knowledge of business life and company management. When managed properly, poor countries that open themselves up to the outside world can achieve more rapid growth than the industrialised nations through what economists call "catching up". Sooner or later even the poorest are raised to a higher standard of living with a more even distribution within the country. One example of this type of development is parts of China, after the country began to turn outwards and liberalised its economy.

Some conclusions

Now back to Lars Göran's question: Does globalisation have anything to do with the closing of the ATM? Yes and no.

In a dynamic economy with rapid growth, the production of goods and services is constantly changing. There is cost cutting, restructuring, closures, innovations and new production starting up all the time. When an ATM gives rise to more costs than it brings in income, it is closed down and bank services have to be handled in a different way, sometimes at higher costs to the customers, but always at lower costs to the bank. These are the conditions in a market economy. Globalisation speeds up the process by increasing competitive pressure. The closing down of the ATM may occur sooner than it would have otherwise. But the tougher competitive pressure provides us with other services, e.g. we can sit at our desks at home and pay our bills via the Internet as well as making transfers between wages accounts and bank loans. And we can pay by card. The ATM becomes less important. Globalisation speeds up the process in the changes in production and consumption patterns in a competitive market economy. This probably cannot be avoided and if we are careful, it can be turned to our advantage, as has been demonstrated in recent years. And we Swedes have shown that we can quickly adopt technological innovations, such as computers, mobile phones and IT.

Let me finish with a few reflections. I have pointed out the advantages of free movement of capital, but also the instability that has followed in the footsteps of deregulation and the crises that have occurred since the early 1990s. The free movement of capital makes great demands on the countries' economic policy. If it turns out that the crises increase in number and become more profound, the demands for a return to regulation will strengthen. There are already demands for this, which are put forward in various international forums. History shows that periods of liberalisation have been followed by periods of regulation. It is possible that the regulatory frameworks on which the international organisations are currently working will stabilise the foreign exchange markets, but it is also possible that some form of "Tobin tax" will win political support. The story isn't finished yet.