Speech

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The financial crisis and monetary policy

Swedish Shareholders Association

Many thanks for the invitation to participate this evening. For more than a year now, discussions about global economic developments have in many respects been occupied with the financial crisis—the crisis that was first Asian, then also Russian and finally seen as global. Economic analyses are full of words like uncertainty and undpredictability; no one can yet tell what the effects will finally be.

The crisis has clearly demonstrated how mobile capital has become, as well as the close global interrelatedness of national economies. This has intensified the debate about the global financial system, its advantages and drawbacks. How can crises of this type be prevented from happening again? And how can the present crisis be overcome? An answer to the latter question is of major importance for future economic development. Things that happen in Bangkok have turned out to be important for shareholders in Stockholm.

One night in Bangkok

For a number of years the rest of the world regarded the Asian economies as something of a miracle. Their growth was astonishing and the high saving and investment ratios gave the impression that this would continue. Orderly public finances were accompanied by exchange rates that seemed to be completely firm. The prospect of undiminished growth attracted an inflow of capital to the Asian Tigers from investors in the West who were looking for a high return and a greater diversification of risk.

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There is no single factor which explains why the tiger economies changed, in the eyes of investors, into paper tigers. There are even those who argue that the crisis arose not so much from altered economic conditions as from general nervousness among investors. The answer is probably a combination of the two, with a number of economic and political factors that triggered a chain reaction from country to country. One serious problem in these countries was that their banking systems had not been fully prepared for the incoming avalanche of international capital. In much the same way as in the 1980s in Sweden, the good supply of capital had pushed up prices for equity and real estate, thereby creating a bubble. In some countries, moreover, a current-account deficit and the fixed exchange rate had become untenable. Another common denominator was the very short-term profile of external borrowing.

Uncertainty about the future path of these economies gradually grew. Investors became increasingly cautious. The devaluation of the Thai currency in July 1997 caused a sharp reaction. Capital flows to the region were stopped. Currencies depreciated sharply and interest rates rose. The currencies of Malaysia, Indonesia and South Korea followed in the wake of the Thai baht.

The gold turned to sand

At first the crisis was seen as a regional problem, with no substantial effects in other parts of the global economy. Investors focused instead on other regions and last spring there was a quieter, though still nervous, period. This proved, however, to be the calm before the storm. On 17 August the Russian government announced a freezing of rouble debt and a devaluation of the rouble.

This markedly altered the mood among international investors. The combination of an unexpectedly large devaluation and a unilateral suspension of rouble debt payments heightened investors aversion to risks. If this could happen in Russian, perhaps it could happen in other countries, too. The imposition of capital controls in Malaysia accentuated the concern.

The crisis therefore spread to other emerging markets, not least in Latin America. Stock markets fell around the world. The possibility that industrialised countries might be hit by other effects than those related to trade gave the crisis a new dimension. The problems in the US hedge fund Long Term Capital Management (LTCM, perhaps something of a misnomer for a company bent on reaping quick profits on invested capital) aroused fears that large losses might make banks excessively cautious and thereby restrict access to borrowed capital. Many forecasters now began to revise their assessments of global economic development.

Watch out!

The most obvious cause of lower global growth is *decreased net exports* to the crisis-burdened countries. Countries that trade with the debt-burdened countries experience a weakening of growth as falling exports are accompanied by a gradual increase in their imports. At first the direct trade effects were not expected to be all

that large; but as other regions have been affected by the crisis, they may be more pronounced.

New risks then arose that are more difficult to assess because they relate to sentiment and confidence. One factor of importance for the rate of global economic growth is *consumer and business confidence*. There are some statistical signs that confidence has fallen. Future prospects have become less bright above all in the United States and the United Kingdom, but also in many of the prospective euro countries. Swedish households are more doubtful about the general economic future but still believe their personal economic situation will improve. Companies are also somewhat more pessimistic.

Another potential threat to economic growth was detected in the summer and early autumn. The problems in LTCM led to talk of a *credit crunch*. Briefly, this is a situation in which banks, after some bad experiences and loan losses, do all they can to reduce risk exposure and slim balance sheets; as a result, the banks cannot be induced to finance even the most stunning commercial ideas. Without access to investment capital, economic activity declines.

Certain signs of an approaching credit crunch could be discerned in financial markets, above all in the United States. They first took the form of an aversion to supplying credit to all but the soundest borrowers. Later there was a reluctance to provide long-term loans to anyone, regardless of their credit rating.

The weakening of growth and inflation prospects in the light of the financial unrest has prompted central banks to lower interest rates this autumn. The interest rate cuts have contributed to the somewhat calmer situation recently in financial markets. Interest rate differentials between industrialised countries and emerging market economies have tended to narrow from a high level and so have spreads in the western markets between borrowers with different credit ratings. In Sweden, the spread between treasury and housing bonds has fallen from 0.9 percentage points in mid October to 0.5 percentage points at present.

Stock markets have also recovered from the sharp fall during the autumn. In the United States, equity prices have now rebounded to the levels from before the period of nervousness. Current equity prices are notably bullish and mirror expectations of very good growth and high business profits. The recovery on the Stockholm Stock Exchange has not been quite as strong; after a fall of around 40 per cent from July to October, the index is now at the same level as at the end of August.

Although there now seems to be somewhat less risk of the global crisis becoming more profound, it will probably still lead to a weaker international economic development that will also affect the situation in Sweden, not least during 1999. During the autumn the Riksbank's appraisal of both growth and inflation in Sweden has been revised downwards. Inflationary pressure in our economy is very low and expectations seem to have been adjusted to it remaining low. A more detailed picture of inflation prospects is contained in our Inflation Report, which is to be published this Thursday.

The name of the game

Developments this autumn and the way in which the Asian crisis has spread across the globe have broken some market perceptions. Loan payments were suddenly

suspended unilaterally by such a large country as Russia. And the problems in a single US hedge fund turned out to be so large as to render the situation in financial markets uncertain and require rescue operations by the major commercial banks. The world was not quite what it had been. A number of observers, including the Chairman of the US Federal Reserve, even considered that what had happened was without precedent in the global economy.

The crisis has enlivened the discussion about global financial systems. In the short run it is the acute crisis that must be resolved. The interest rate cuts, not least in the United States, have played an important part here. In the longer term, conditions must be created whereby the global financial system functions sensibly. Matters that are being discussed in the longer perspective include the role of the IMF and how to help the problem countries. There is also the question of ensuring that countries and private agents, instead of distorting reality, provide an accurate picture of their situation. Other matters are the construction of systems so that early warnings are sounded if, for example, the situation in the bank sector is becoming untenable, and how to prevent investors from building up such large risks. The discussion also concerns the free movement of capital and how its negative effects can be restricted.

Permit to dwell fairly briefly on these large and important matters. This is a discussion to which we at the Riksbank will no doubt be returning. Solutions to some of the questions are relatively easy to find; others will require a great deal of lengthy discussion over a considerable period and may even then not be entirely satisfactory.

The IMF to the rescue

The immediate resolution of the crises in Asian countries and, most recently, in Brazil has been spearheaded by the International Monetary Fund (IMF). Thailand, Indonesia and South Korea were offered financial support by the Fund, subject to certain conditions. These loan terms concerned both the formulation of economic policy and some structural measures. Interest rates were to be increased, accompanied by fiscal restrictions to restore a balance or a surplus to government budgets. Consolidation of the banking system and stricter supervision were also required. Reforms in other fields were demanded to make the economy function more efficiently.

The economic recession in the problem countries turned out to be considerably deeper than expected. The IMF has been criticised for requiring tough restrictive measures. With growth in the Japanese economy at a standstill, moreover, these countries did not have the benefit of an external stimulus. International investors and banks were not prepared to renew loans to countries which had obtained support from the Fund. The currency depreciation continued. Some adjustments were made to the IMF programmes.

Broadly speaking, the Fund's management of the crisis has been criticised from two standpoints. One is that the Fund's terms are too harsh and tend to contribute to domestic poverty without any benefits in real economic or financial terms. The other standpoint is that the IMF hands out money far too readily to all-comers without demanding enough in return.

The support currently provided by the Fund is intended to enable the crisis-burdened countries to spread the necessary adjustments over a longer period than would otherwise have been possible. There is then less risk of output falling

sharply. It can also help to forestall financial market unrest. The latter can benefit other countries that might otherwise be hit, more or less undeservedly, by large movements in exchange rates and interest rates. Moreover, IMF support can induce other lenders to provide financial assistance. The programmes drawn up by the Fund have led industrialised countries to come forward and contribute financial support.

In situations like this the IMF can also serve as a much-needed whipping-boy. Governments in crisis-burdened countries can point to the Fund as the task-master behind various measures and thereby achieve reforms that are essential but troublesome.

All this presupposes that the Fund's demands on the crisis-burdened countries are properly balanced. The programmes must make financial markets confident that the countries will ultimately be able to repay the loans. Some critics consider that the IMF, instead of adapting to the changeover from previously regulated markets to globally interrelated markets, is simply following the beaten track without sufficient heed to the new environment.

Earlier crises had more to do with purely macroeconomic factors which the IMF could remedy by following a relatively simple diagnostic procedure—focusing on the balance of payments—and prescribing the medicine that suited the country in question. Today's crises call for measures over a wider field. Ordering an interest rate increase, for instance, as a cure for exchange rate instability is not as self-evident a solution when higher interest rates are liable to worsen a weak banking system's difficulties or undermine government finances.

At the same time it is important that the IMF concentrates on the crisis-burdened countries' fundamental macroeconomic and financial problems. An ambition to tackle a wider range of issues may run into trouble. No matter how well-grounded the structural changes may be, the Fund can, for example, be accused of exerting an undue influence on policy in the problem countries or of serving the trade policy interests of other countries.

There is broad agreement among the industrialised countries that it is the IMF which should act in situations like the one in Asia. The IMF is also our own organisation; Sweden is represented on the Board and cannot dissociate itself from what the Fund is doing. An active discussion is now in progress to learn from recent developments. So far, however, no general consensus has been reached except as regards increased transparency in many respects.

Openness and oversight

One recipe for a sounder financial system that has been discussed and agreed on is *better transparency* both among private players and on the part of the IMF and various public agents.. Some of the problems could be avoided if a fair picture of the situation were provided, for instance by ensuring that statistics are correct and generally available. In some cases, investors' assessments concerning Southeast Asia had a misleading foundation, for example as regards the situation among banks and large companies as well as the size of foreign reserves.

Advocating more transparency comes naturally to a Swede. We put the case frequently, at home as well as in international fora. The IMF, for example, ought to be able to present its country assessments more openly. We have already taken steps in this direction that we hope will exert natural pressure on other countries to do likewise. At the same time, this is a good illustration of the IMF as the sum of its

members. Even in the group of Nordic countries there are members that have pulled in a different direction.

The IMF should also go further in explaining its actions so that these are better understood. Just as we consider that independent central banks have to be open in order to gain support for what they are doing, so must the IMF generate greater popular and political support for its work.

Another requirement for a sounder financial system is *better oversight and supervision* of the financial system in each country. Over the years there have been numerous instances of where the combination of free capital movements and inadequate supervision can take us if things go wrong. As Swedes, the bank crisis in the early 1990s gave us a ringside view of the consequences. One good result of that crisis—a late compensation, if you will—is that today the Swedish banks are less exposed.

A decade ago, international agreement was reached on the amount of capital banks are required to hold so that they are in a position to weather troublesome times. Last year the Basle Capital Adequacy Requirements was augmented with 25 core principles for determining whether or not a country's banking system is sound and its bank supervision effective. A first step towards better bank supervision is to ensure that more countries are in fact complying with the rules and principles that have already been established. It has been proposed that a country's access to capital from the IMF be linked to the degree to which it observes these principles. The competent national institutions for banking supervision should also be scrutinised and adapted, so that they possess the resources for coping with the new financial environment.

Another step towards better supervision involves an ongoing development of the existing rules and regulations so that they are appropriate for today's reality. One matter that is being discussed is a review of the capital adequacy standards. The banks' lending operations, for instance to LTCM, were astonishing. In this context I can mention the discussions that are in progress about highly indebted players and how they can be included in supervision to prevent them taking unduly large risks.

Sound risk diversification

One of the issues—probably one of the knottiest—that are being discussed is how problem countries can obtain financial support without this giving rise to expectations that a country with financial problems will always be rescued by some international institution.

If private investors get the idea that any profits will accrue to them and can rest assured that someone else will intervene and absorb any losses, they will be all the more prone to take risky positions. Investments that would normally not be attractive will find takers because there is everything to gain and nothing to lose. This can result in the form of moral hazard that involves unduly risky behaviour. Signs of such behaviour have been found. Spreads between government bonds issued by industrialised countries and emerging market countries such as Russia suggest that investors expected to be bailed out and were therefore not demanding full compensation for risks.

Moral hazard could conceivably also result in a particular country or countries taking excessive risks, though this is presumably much less likely. The political cost

to a country of becoming bankrupt is exceedingly high, as is almost too clear from developments in South Korea, Thailand and Indonesia.

So what can be done to counter moral hazard in the financial system? One, seemingly self-evident, remedy is to get the private players to carry a larger share of the burden when problems arise. That in turn could make them act more prudently. This is being discussed. The crux, however, is that the investors and banks concerned are caught in what is known as prisoner's dilemma. Smart investors count on being able to take a little extra risk and then be the first to exit when things go wrong. The dilemma they face, however, is that when everyone makes a simultaneous dash for the exit, most of them are trapped because the market then ceases to be liquid.

One possibility is a system, involving a third party, whereby individual investors are made to realise that less headlong behaviour in the throes of a crisis could be more advantageous for them as well as for everyone else. The remaining cake can then be divided more fairly among all those involved. One procedure for this, adopted in connection with the Asian crisis, could be to monitor bank lending globally. This was tried out in the case of South Korea; the banks were persuaded to renew credits pending a more orderly solution. Another matter that is being discussed is how bonds could be constructed with a clause that makes it possible to implement the type of procedure that applies to default.

The markets and capital movements

The Asian crisis has clearly demonstrated the mobility of international capital. Technical and financial developments have meant that positions can be taken and closed much more quickly than before.

Some of the rapid shifts in many countries' exchange rates and interest rates do not seem to have been motivated by changes in the macro economy or other fundamental factors. This raises difficult questions. Capital movements of this kind may ultimately elicit political reactions that threaten the existence of free capital markets.

The complexity of the issue is illustrated by consequences of the new Basle rules. These rules prescribe capital cover for the marked-to-market value of many assets. This is basically a good thing in that it reduces the risk of failures. But together with the models on which risk assessments are based (using historical data), rules of this type probably also tend to accentuate flock behaviour among international investors. Continuous marking-to-market does give a fair picture of the situation in each company but probably also leads to an increased need for quick financial rearrangements. A price change in one country immediately alters the spectrum of risks and this triggers a wave of buying and selling.

Perhaps we must acknowledge at this stage that we have been a little too optimistic about the workings of the international financial system and self-regulating mechanisms, in much the same way as we were about Sweden in the late 1980s.

Seen in this light, the demands for extensive capital controls that are now being aired in the debate are hardly surprising. This would not be practicable, however, particularly not in the longer run.

There are examples—Chile in recent years is one—where measures for controlling short-term capital seem to have worked well. It should be underscored, however, that these measures have been one item in a very soundly implemented

economic policy that also includes tight budgets, institutional and growth-enhancing reforms, and lower inflation.

Chile's experience is therefore by no means directly applicable to other countries. Another important point is that Chile's aim has been to become less dependent on short-term foreign capital. The measures have not restricted outflows—which is liable to be counterproductive—but made inflows less attractive.

Just where the discussion of capital movements will take us remains to be seen. Here, too, there is reason to underscore the importance of transparency and rules that work properly. Another matter that has been raised in the debate is the importance of carrying out deregulations and structural changes both in an orderly manner and in the right sequence.

Measures of this type will probably not suffice to solve all the problems connected with free capital movements. A continued discussion is therefore needed without an unduly strong ideological gloss. However, such a discussion is unlikely to result in any dramatic changes in the international financial system.

The winner takes it all?

The world economy has recently been going through a deep crisis—an Asian crisis that has acquired a global dimension. The ultimate effects of the crisis are difficult to predict but its course to date should be a lesson to many.

- Households have been reminded that saving in equity is not without risks. How long this reminder will last is another matter—US stock markets have already shot up again towards new all-time highs.

- Large investors with a high level of debt have also been cautioned. An exceptionally high return presupposes exceptionally high risks and thereby entails large losses if things go wrong.

- The banks have learned similar lessons, particularly those that used highly levered funds as a way of accommodating high risks.

But even those who function as overseers of financial systems—governments and central banks—have learned something from the latest crisis. Work has been stepped up to create a lastingly robust framework for the satisfactory functioning of the global financial system.

Today I have concentrated on the financial system in the longer perspective. But in the midst of all the uncertainty about the present situation, there is one thing about which we can be quite sure: this is not the last financial crisis. Now that the situation in financial markets has become somewhat more stable, we should not suppose that everything is all right again. The financial market players—savers, investors, fund managers, supervisors and overseers—must not lower their guard. Not again.