Lars Nyberg: Financial disturbances and the real economy

Speech by Mr Lars Nyberg, Deputy Governor of Sveriges Riksbank, to Danske Securities, Stockholm, 11 March 2002.

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I would like to begin by thanking you for the invitation to come here to Danske Securities and speak to you, who are at the real heart of the financial sector, but also heavily dependent on occurrences in the real economy. In my speech today I intend to concentrate mainly on the relationship between developments in the real economy and financial developments, as it has looked in the past and as it may look in the future.

The Riksbank's two objectives, maintaining price stability and promoting efficiency and stability in the payment system in a broader context, have both real economy and financial aspects. The objectives are more closely linked than might be thought initially. Turbulence on the financial markets has repercussions for economic activity and developments in the real economy and thus great significance for the shaping of monetary policy. It is difficult, if not impossible, to pursue an effective monetary policy when the financial markets are functioning inefficiently. At the same time, price stability and stable, low inflation expectations help to create security and stability in the financial markets.

This far it is quite simple. It is rather more difficult to make an in-depth survey and understand the relationship between the financial and the real economies. Moreover, developments in the financial markets are very rapid and there is every reason to believe that the relationship changes over time.

If one looks back at global developments over the past year, the financial markets appear to have coped with more and greater shocks than many would have thought possible. The IT and telecom bubble burst, a simultaneous international slowdown in economic activity began, Turkey experienced a financial crisis, the USA suffered terrorist attacks on 11 September and began a war against Afghanistan and the American energy company, Enron, collapsed. Finally, Argentina suffered a severe crisis. The private market operators were not saved by further measures from the IMF, as many had expected. However, not even all of these events together appear to have had any serious long-term effects on the global financial markets.

In addition, it now seems as though the repercussions for the real economy were relatively slight, despite the fact that households and companies, particularly in the USA, were heavily indebted when the economic upturn began. Does this mean that we can now write down the risk of financial imbalances and crises delaying the economic upturn most analysts predict to be on its way? Have economic policy, the financial infrastructure and the behaviour of market operators been adapted to the globalised, technologically well developed financial markets to the extent that the contagion effects on the real economy of financial disturbances has declined significantly during the past decade? These are questions I wish to discuss now, however more with the aim of provoking some interesting ideas rather than providing any ready-made answers.

Are the markets more robust?

Let me begin with the question of whether the markets have really become more robust, in the sense that they are now less sensitive to disturbances. There are some arguments in favour of this theory. One of these is directly linked to monetary policy and inflation. This is namely that an increasing number of countries have abandoned the ambition of maintaining a fixed exchange rate and chosen instead to focus their monetary policy directly on an inflation target. Openness and transparency have increased as a result of this, which in itself has probably improved the functioning of the markets. Inflation rates and inflation expectations have fallen and become more stable, which has led to significantly lower nominal rates. Uncertainty with regard to the future has thereby declined and the conditions for making the right investment and savings decisions have improved. All of this should have increased the stability of the markets.

However, there are other arguments. Greater awareness of the need for maintaining central government finances under control has increased budgetary discipline and led to reductions in central government debts in most countries. It could possibly be claimed that the stricter budgetary discipline

is a rather last-minute conversion, as countries with large deficits are often forced to borrow on the international markets and there submit to the requirements made, in only to keep down the loan costs.

Large, growing budget deficits also reduce the possibilities for parties other than the central government to assess the future and increase their costs. Borrowers are forced to pay high and varying risk premiums to borrow on the bond markets, as financial investors want to be paid for the uncertainty regarding the inflation rate or exchange rate. In addition, there is always a risk that if the debt becomes too large the central government will be forced to implement large savings that will in themselves lead to increased unemployment and poor profitability for domestically oriented companies.

Large international efforts have been made and are being made to create new regulations and standards that will reduce the risk of financial instability in a deregulated environment. The Basel Committee's new capital adequacy rules are an example of this. Financial supervisory authorities in most countries have been strengthened considerably, although the complexity of the markets always threatens to increase more rapidly than the competence to supervise them.

Quantitative deregulation of the financial markets is largely complete and the adaptations have been made. Increased experience of acting in a deregulated environment should in itself have reduced the risk of financial crises. The banks, which are particularly important because of the role they play in the payment system, are better capitalised than they were a decade ago. Credit risk management has also improved considerably. This applies in particular to the Swedish banks, which are now much better equipped to manage risks than they were prior to the bank crisis at the beginning of the 1990s.

Central banks and financial supervisory authorities have also become better at assessing risks. Looking back, the really devastating bank crises have stemmed from a combination of soaring property prices and rapid growth in bank lending, and they have often taken place in countries with a fixed exchange rate. A growing number of central banks now closely follow macroeconomic factors that could lead to a build-up of imbalances in the financial system and publish their conclusions in special stability reports. The Riksbank is one of the forerunners in this field, based on the experiences gained from the Swedish bank crisis.

For some years now, the IMF has carried out assessments of the functioning and safety of the entire financial sector in both developing countries and industrial nations. Sweden was subject to one of these FSAPs (Financial Sector Assessment Programs) last year and this year it will be the turn of Japan and the United Kingdom. These assessment programs compare the entire financial systems of the countries; banks, clearing houses, payment systems, legislation, supervisory authorities, central banks, etc. with the "best practice" in the world and any shortcomings are pointed out. Each country can then choose whether or not to publish the results of the assessment. A summary of the assessment is included in the IMF's annual assessment of member countries' economies.

Dependence and complexity are increasing

While the markets have thus (hopefully, I should perhaps add) become more robust, our use of them has grown. Households and companies have become operators on the financial markets, mainly because these offer better and cheaper services than those traditionally offered via the banks. An increasing percentage of the investments made are financed on the market through shares and bonds in other countries than the USA. This has become possible because households' savings are to an increasing degree channelled into shares and mutual funds. We use the financial markets much more than we did just ten years ago. This means that we have good reason to be concerned over their functioning. It has also meant that questions regarding financial stability have acquired greater importance on the international political agenda.

At the same time as use of the markets has grown, new instruments are being traded that are increasingly complicated in structure and their risk content has become more difficult to assess. Various forms of derivative have been developed, for instance, to spread risks more efficiently. This in itself creates conditions for reducing the vulnerability of the banks as well as the financing costs of the investments. Essentially, this development benefits long-term growth. In recent years, the use of credit risk derivatives and securitisation has increased, for instance. However, there is a risk that the complexity of these instruments will increase the difficulty of seeing to which credit risks companies and banks are actually exposed.

The complexity of the financial instruments and the fact that they are often found, in various forms, on both the asset side and the liability side of companies' balance sheets as well as "off balance sheet", makes it difficult to detect the financial risks within banks and companies. This is particularly serious as an increasing number of households have their savings in these companies' shares, but nor is it easy for professional analysts and portfolio managers to see.

The collapse of the American company Enron can serve as an example of the problems connected with the development of complicated financial instruments. A lack of understanding of the instruments used and a lack of transparency in the company's accounting meant that directly after the collapse there was considerable concern over possible contagion effects. Here I do not mean the evident breach of the regulations in force, where auditors burn documents and senior managers sell shares in the company prior to publishing negative information. Enron raises a number of other, in the long term more fundamental, issues. Today, I shall limit myself to discussing three of these.

Firstly, Enron was basically an energy company, which in time came to pursue financial operations on a large scale, but without coming under the supervision to which financial companies are normally subjected. The lack of supervision also applied to Long Term Capital Management, LTCM, some years earlier. One might wonder whether function rather than company type might not be a better base for supervision. There is otherwise a risk that functions essential to society and thus needing protection will be transferred to companies not subject to supervision. At the same time, the public sector is in practice forced to intervene if the failure comprises a threat to the system, regardless of whether it has been able to exercise supervision. To what extent Enron was involved with functions that can be assessed as worth protecting is a question for discussion, but it is an important question of principle. We cannot and should not regulate all companies involved with financial operations, e.g. in managing their own funds.

Secondly, it appears obvious that accounting regulations, at least those in the US, have not developed at the same rate as the instruments and forms for capital acquisition on the financial markets. Is it really reasonable in the long term for an increasing number of companies' risks to be reported off balance sheets? In the case of Enron, it also appears that there were risks that did not need to be reported at all, according to the regulations in force, such as liquidity risks that were triggered by a down-rating.

Thirdly, it is educational (and frightening) to see exactly how the shortage of liquidity brought about Enron's downfall when questions were raised regarding the quality of the balance sheet and the market lost confidence in the company. Enron's balance sheet had some similarities with that of a bank, in that the liabilities side consisted of borrowing that proved to be rather short term, while the asset side was difficult to value and had much poorer liquidity. A bank that found itself in an equivalent situation could face a run, with customers withdrawing their deposits, and this was really what happened to Enron. This makes some form of liquidation necessary, even if there later proved to be some value left in the balance sheet.

The experiences of the Enron case led to investors temporarily fleeing companies with complicated constructions and ownership or companies suspected of being rather too creative in their accounting. However, this seems to be just a temporary phenomenon. Companies' credit spreads have not been affected as much as was feared and the stock market shook a little, but has begun to recover again. The effect appears rather to have been that accounting methods and procedures have been voluntarily revised, a development welcomed by both market operators and authorities alike.

Perhaps the Enron case can become a further indication that the markets have actually become more robust. However, the Enron collapse also illustrates clearly some of the risks that might arise when the markets grow in both significance and complexity. These risks and their effects on the real economy should not be underestimated. The markets' increasing dependence on one another both within and between countries could lead to considerable contagion effects when there is a disturbance in one part of the system.

To summarise; the risks of large financial imbalances building up in economies have probably declined over the past decade as a result of more predictable economic policy. Regulations and risk management systems have also improved. At the same time, the complexity of the financial instruments and the opportunities for extensive positions off the balance sheets have increased the difficulty in assessing future profits and risks in companies. Meanwhile, increased saving and financing in market-listed instruments have made households and companies more dependent on the safe and efficient functioning of the financial markets. This could mean that the effects of disturbances from the

financial system on the real economy could increase in the long term if regulatory frameworks and supervision are not adapted sufficiently rapidly.

Can we live with large imbalances?

When share prices plummeted almost two years ago and when uncertainty increased following the terrorist attack in September last year, there were fears that expectations for the future would be revised down so strongly that households' willingness to consume and companies willingness to invest would decline drastically. The fears concerned the US economy in particular, but the uncertainty was also expected to affect the rest of the world. The high level of indebtedness built up during the economic upturn in many countries significantly increased this risk. Positive expectations of the future had increased companies' financing needs for investment. At the same time, a bright picture painted of the future and an increase in wealth had stimulated households' consumption and increased their investment in housing.

It was easy to imagine a risk scenario where household sector demand declined so rapidly that heavily indebted companies went bankrupt, where unemployment rose drastically and where banks an other lenders suffered extensive loan losses. This negative spiral could continue with further falls in share prices and household wealth and rising credit risk premiums would make lending more expensive. If this negative sequence of events were not broken, high loan losses could eventually lead to bank crises and credit crunches, which would contribute further to the downward spiral.

A credit boom, large increases in asset prices and a high rate of growth in investment, often concentrated on a particular sector, have been the factors preceding serious financial crises around the world. However, it is important to remember that neither a credit boom nor a large deficit on the current account need be interpreted as an accumulation of financial imbalances. If savings and investment decisions are based on realistic expectations of future growth and banks and financial investors have been able to make realistic assessments of the credit risks connected with investment projects and consumption loans, then this development is more a sign that the international capital markets are functioning efficiently. The task of the capital markets is to channel capital to investment projects with a high return. If financial investors assess the return on investments in a particular country to be higher than in other countries, there is reason for the exchange rate to strengthen. One cannot rule out the possibility that this is exactly what happened in the USA.

Whether the level of indebtedness, the deficit on the current account and the strong USD exchange rate comprise a significant risk of large fluctuations in growth and a threat to global financial stability in the near future depends to a great extent on whether the long-term growth in the US economy will develop much more weakly than was expected when decisions on loans and investment were made. And, as I mentioned earlier, the shaping of economic policy and improvements in regulatory frameworks and risk management systems should have reduced the uncertainty in investment and savings decisions and thereby also the risk of a build-up of large financial imbalances. However, it remains to be seen whether globalisation, IT and telecommunications technology and perhaps also more efficient financial markets have really created the potential for higher growth that lay behind the expectations that pushed up economic activity. So far, the economies have reacted fairly moderately to the shocks they have faced over the past year. The risk of financial imbalances being built up as a result of over-optimism still remains, but is now assessed to comprise less of a threat to the recovery of the economy than was previously thought.

Monetary policy considerations

Developments over the past months also indicate that the risks of a profound and prolonged international economic slowdown have declined considerably. There are a number of signs that the lowest point has now been reached. One condition for an upturn in international economic activity is that growth in the US economy picks up. Productivity has continued to develop very positively relative to the economic situation, which is a good sign. The fact that American households' demand for consumption has improved since the autumn also indicates that the lowest point has been reached and a turnaround is on the way.

The unease that has existed, and which was accentuated after the terrorist attack on 11 September, over the possibility that rapid and perhaps exaggerated adjustments of financial imbalances in the American households' and companies' balance sheets might cause a deeper decline appears, at least

so far, to have been quite unfounded. Better functioning financial markets as a result of the changes in economic policy and the improvements in regulatory frameworks and supervision that I mentioned earlier may have contributed to this. If so, the level of indebtedness in the corporate and household sectors should not comprise such a great threat to economic activity in the coming years as many have feared, including the Riksbank in a number of Inflation Reports.

In Sweden, the decline in economic activity has not affected capacity utilisation and unemployment to the same extent as in previous cases in the economy. This means that the upward turn will be from a relatively high level of resource utilisation in the economy. Low interest rates, a weak krona and a very expansive fiscal policy have been contributing factors here. One consequence of the high level of resource utilisation could be the unexpectedly high inflation rate registered recently. Earlier price increases on certain product groups are assumed to be temporary, which would mean that inflation should fall this year. However, price rises in the services sector, for instance, probably reflect higher labour costs. A number of my colleagues have expressed concern over future inflation and I must say that I share their concern.

The fact that the international upturn in economic activity is taking place after a very brief and moderate decline means that the economic upturn is not expected to be as strong as earlier upturns. For Sweden, this means that exports are increasing, but that growth is primarily expected to come from domestic demand, in particular in the services sector. In my opinion, this increases the risk that domestically-oriented companies with pressurised profit margins will continue to compensate themselves for cost increases by raising prices.

This is roughly how the picture looks as the Executive Board of the Riksbank gathers on Monday 18 March to discuss the economic situation and monetary policy. We will also have as a basis for our decision a completely fresh Inflation Report, which will be published on the following day.