

Jean-Pierre Roth: Implications for business of the new international monetary order

Address by Mr Jean-Pierre Roth, Chairman of the Governing Board of the Swiss National Bank and Chairman of the Board of Directors of the Bank for International Settlements, at the Annual Conference of the International Business Academy, University of Fribourg, Fribourg, 8 December 2006.

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It is a pleasure for me to be here discussing one of the most important issues of our times: financial globalisation and its implications for international business. Globalisation, the landmark of the dawn of the 21st century, has opened up new opportunities for growth and prosperity on the planet. It has created fantastic investment perspectives to those firms that can compete internationally. But it has also changed the rules of the game and brought about new challenges.

Today, the success and the survival of international business are determined more than ever at the private level. Because goods and capital are free to move across national borders, protection from risks emanating from globalisation can be a matter for private strategy only, rather than public policy. This, I think, is the main difference between the globalised world of today and the partitioned world of separated nations in the past.

Let me share with you my views on how the globalisation of financial markets and the concomitant emergence of a new monetary order have changed the playing field for international business, and on what roles you, the private sector, and we, the central banks, are now called to play.

What is the new international monetary order?

The globalisation of finance has led to important changes in the ways monetary authorities implement their policies. Over the last decades we have witnessed the reorganisation of the world monetary order, with choices polarised around two extremes: at one extreme the flexible exchange rate regimes such as the ones in the USA, the UK and in Switzerland, and at the other extreme very fixed regimes, such as the monetary union chosen by the countries belonging to the euro area. Pegs still exist, especially in Asia, but they are less numerous than in the past.

Let me talk first about how different national monetary choices meet the challenges of financial globalisation. We have left behind us a time where international monetary relationships, based on the Bretton Woods system of fixed exchange rates, gave us a nice feeling of order and security. The keepers of that order were central banks, and their main job was to maintain the exchange rates for their currencies within a narrow band. International businesses, for their part, were free to plan ahead, unaware of nasty surprises emanating from sudden currency exchange disorders.

And yet this world of apparent security collapsed. By the late 1960s, fundamental misalignments between the major economies had become too great to support an international fixed exchange rate system and, reluctantly, we had to accept that the security we had taken for granted had become an unsustainable fiction: with ever growing international capital mobility, pegged regimes had become increasingly difficult to maintain. The reason is easy to understand: with capital free to move across national borders, the price of any currency is determined like the price of any other internationally traded asset – through the interaction and expectations of actors that operate beyond the borders of the issuing country and in response to variables that are beyond the area of influence of national authorities. By the early 1970s, central banks could not ignore this basic truth, and by 1976 all major currencies were floating. The Bretton Woods system was dead.

In the decades that followed, many countries, especially developing ones, tried to cling to a dollar peg with periodic adjustments, in an effort to bring stability to their currencies. They were operating what economists call intermediate exchange rate regimes. The series of costly crises of the 1980s and 1990s proved how dangerous this path could be. The adjustable pegs that were able to channel thin capital flows were completely ineffectual when it came to containing the huge capital flows

encountered in a more globalised world. By 1996, flexible exchange rates predominated in Africa, Asia, the Middle East, non-industrial Europe and the Western Hemisphere.¹

Today, many advanced countries and emerging economies have adopted a flexible exchange rate regime.² By this I understand a regime in which the exchange rate is basically left to fluctuate in response to market pressures. True, the central bank can, and in some circumstances will intervene to mitigate extreme exchange rate fluctuations. But the main objective of the central bank is domestic price stability, not exchange rate stabilisation. This is the system that Switzerland has chosen to pursue. It has served us well. Exchange rate flexibility allows national budgetary and monetary policies to diverge from one country to another. It confers monetary authorities more room to adapt policies to domestic economic realities.

A different strategy has been followed by many European countries. Abandoning their domestic currencies, these countries have fully insulated themselves from intra-zone exchange rate fluctuations by adopting the hardest possible peg, which is a monetary union. Monetary policy is the responsibility of a supranational institution, the ECB. Towards the rest of the world, the euro is allowed to float, and the necessary adjustment of prices in member countries, rather than taking place via movements in the exchange rates, is expected to occur by means of changes in wages and product prices in an increasingly integrated economic area.

Thus the Bretton Woods system has been replaced by an order of sorts, in which there are two extreme choices which increasingly dominate national strategies. At the one extreme, countries have opted to let their currencies float and be determined by market forces. At the other, some countries have opted for full insulation from exchange rate fluctuations by renouncing monetary independence.

Consequences of the new international monetary order

What are the consequences of this new international monetary order? The first positive consequence is undoubtedly the increased stability of the international monetary system. Indeed, one of the paradoxes of our times is that the apparent disorder of today is far more stable than the apparently ordered system of the past. In the presence of high capital mobility, the two most resilient exchange rate regimes are those that today dominate the planet: very flexible regimes and very hard pegs. The move away from intermediate regimes has reduced the probability of costly financial crisis. Thus the priority given by central banks to price stability and the abandonment of the exchange rate anchor has resulted in more – rather than less – foreign exchange stability. Evidence of this are recent potentially destabilising events, like the recent war in Lebanon, which have passed without major international financial turmoil.

This brings me to the new division of labour between private and public agents that I mentioned in the introduction. The increased stability is based on a new contract between society and monetary authorities: Those countries that, like Switzerland, have chosen the flexible exchange rate regime, base the success of their monetary policy on the credibility and transparency of their central banks. We are no longer – thankfully – attempting to construct a kind of Maginot line to contain international capital flows. This effort would be as costly and as ineffectual as the Maginot line itself was. Instead we, the central banks, are endeavouring to provide markets with timely, clear and reliable information on our views about the future path of inflation and the effect this may have on our interest rate policy. You, the private sector, analyse this information and act upon it. Unlike the situation in the past, when international businesses were led to believe that the future path of exchange rates was predictable, today we have a more realistic situation in which the business community knows that shocks can occur, and that what is predictable is the way in which the central bank will react to them.

In addition to a more stable international monetary order, this new paradigm has brought us many other advantages: Lower inflation, lower real interest rates and lower international spreads are additional achievements. After decades of high inflation and even recurrent episodes of hyperinflation in various emerging markets, the last ten years have been marked by low stable inflation in most

¹ Caramazza, F. and J. Aziz (1998), 'Fixed or Flexible? Getting the Exchange Rate Right in the 1990s', IMF, *Economic Issues* 13, April.

² Eichengreen, B. and Raul Razo-Garcia (2006), 'The Evolution of Exchange Rate Regimes', *Economic Policy*, July, pp. 309-442, Table 1.

countries of the world. Price stability has benefited all. Consumers benefit, of course, because their income is no longer eroded by price growth. But producers have also gained because price stability helps them to plan ahead. Lower inflation and confidence in central bank policies have, in turn, reduced uncertainty about future price developments. The lower inflation risk premium is allowing even industrial economies to grow at lower real interest rates than in the past.

And, finally, an unambiguously beneficial consequence of the new international monetary order is that it allows for more efficient distribution of capital. At the same time as the current polarisation of exchange rate regimes has come into being, financial globalisation has intensified. Capital controls are being lifted in a growing number of developing countries. In the 1970s, net flows of private capital to the world's poor countries amounted to a little over 1% of host-country GDP.³ By the end of the 1990s, this percentage figure had grown by a factor of three. Today, there is a broader acceptance of the benefits to be derived from financial liberalisation.

Indeed, the gains expected from a free market for international capital are substantial. Global finance allows for a better allocation of world resources, enhancing the prospects for growth of all nations. For richer countries of the world, there are new investment opportunities to finance the expanding needs of their aging populations. Younger and poorer nations obtain access to capital to realise their high potential growth. This is the basic teaching of the theory of international capital flows. Financial integration, together with technological advances in financial markets and financial market instruments, is benefiting the world at large by allowing capital to be invested where returns are higher.

Where are the risks?

But these benefits also entail new risks. Indeed, despite better institutions, better policies and better markets, we feel more vulnerable nowadays than we used to in the past. How can we reconcile this image of a more prosperous and safer world with our increased feeling of danger? To some extent, our sense of vulnerability simply reflects advances in telecommunications that have enhanced our awareness of the world. I am not a geologist and therefore I cannot tell you whether we are now experiencing more earthquakes than we did 30 or 40 years ago. However, I do know that nowadays I am informed within hours, if not minutes, of any earthquake, flood or terrorist attack that occurs, even in the remotest corner of the planet. Our sense of security is bound to be affected by this kind of information.

But it is not just a matter of perceptions. Globalisation means that we in Switzerland are indeed affected by events occurring in India, Brazil, Australia, Japan, Argentina... To a certain extent, our perception of heightened vulnerability is justified. SARS (severe acute respiratory syndrome) or "bird flu" have the potential to become pandemics of unprecedented reach because we travel more than in the past. A terrorist attack in any city around the globe will be felt immediately by investors worldwide. Global companies may see their chains of supply disrupted by strikes in far away lands. We have no control over these events and no possible way to guess where the next catastrophe – natural or manmade – will occur.

Let me return to global finance. I have said before that the world today is less likely to witness the recurrent crises that afflicted so many countries in the 1980s and 1990s. I am convinced that this is the case. By choosing a flexible exchange regime, they have chosen a more resilient system, and many of them are pursuing sensible macroeconomic policies that should help them navigate turbulent waters more safely than in the past. But I am also convinced that not all countries are equally well prepared to cope with free capital mobility. For those countries with weak institutions and underdeveloped financial sectors, globalisation means more rather than less vulnerability. International financial integration may look like a blessing when foreign capital flows in, but it will look like a curse when foreign investors head for the door. The present monetary order is more resilient than the previous regime of fixed exchange rates, but crises can still occur, and if they occur they are more likely to be extensive and spread rapidly.

And globalisation, of course, goes far beyond financial integration. Global companies are located all over the world. They have to deal with different legal frameworks, with different business cycles, with different political realities. The range of risks to be met by international business is thus far broader

³ The Economist, Global Finance Survey May 2003.

than in the past and demands permanent monitoring and continuous improvement of risk management at all levels. Financial, operational and reputational risks are all new by-products of globalisation, and we are only just beginning to come to terms with them. A survey of corporate directors quoted by the Economist in 2004 showed that a clear identification of risks is still too difficult for many well trained CEOs: 36% of the corporate directors polled actually admitted that they did not fully understand the risks faced by their company.

Implications for the private sector

With globalisation, your lives have undoubtedly become more difficult. Operating at a global level is infinitely more complex than the regional approach of the past. Globalisation is a challenge for business management. It entails many sources of uncertainties but also offers many vehicles to cope with risk.

Can we beat these new risks? No. We must prepare ourselves to face them. We can only insure against some risks, but we cannot predict where the next blow will come from. I think that this is the most important characteristic of our times. What has increased is not our insecurity. We are, in many respects, safer than in the past. This, I hope, is what I have managed to convey to you. My conviction is that the world today is better managed than in the past and, in that sense, is safer. What has increased, however, is the magnitude of a potential crisis. This is what I refer to as uncertainty. The big challenge for international business of today is to learn to live with uncertainty.

And in this domain we still have a way to go. Nowadays, our difficulties in dealing with uncertainty permeate all our discussions about the responsibilities of different private and government agents. I perceive an understandable – but in my opinion misconceived – nostalgia for a world that used to appear safer, thanks to regulation. We hear demands for the construction of barriers to protect ourselves from the menacing world outside – demands for more regulations to ensure that financial providers cannot go bust, cannot cheat, cannot make wrong decisions; more trade barriers to ensure the survival of domestic producers; more restrictions to the movement of persons to protect our workers... The problem with this dreamworld cocoon is that it has never worked and will not work. And what is even worse, if it did work, if it were possible to barricade ourselves against all possible menaces, we would still not be better off.

Globalisation is a great opportunity and it can make us all richer and safer. But we have to learn to live with risk. In fact, the main danger I see today is that because we live in a more stable world, in a safer world, we may become complacent. And here I must say that I do not feel comfortable with the recent developments in financial markets. The surge in asset prices in many countries, the absence of volatility in many markets and the low level of credit spreads show that today's investors have an unprecedented confidence in the future and a strong appetite for all types of risks. For sure, economic fundamentals have improved in industrialised and in emerging countries. It is, however, hard to believe that the world economy has now entered a phase of lasting and accelerating prosperity.

We must remain alert. No major financial crisis has shaken the world in recent years in spite of the Iraq war, rising oil prices, major natural disasters, various terrorist attacks and permanent rumours of new terrorist attacks. The resilience that financial sectors have shown may cause us to forget that crises are still a possibility.

Thus, the major challenge for international business today is, to my mind, to keep a weather eye open even when the waters appear calm.