Mr. Fazio considers the issue of efficiency and instability in global finance

Address given by the Governor of the Bank of Italy, Dott. Antonio Fazio, at an international conference celebrating 50 years of Quarterly Review/Moneta e Credito in Rome, on 20/11/97.

In the wake of the Great Depression and the Second World War, the new monetary system set up by the Bretton Woods agreements, together with the liberalisation and expansion of international trade, laid the foundations for a long period of economic growth and stability.

From 1950 to 1973 the world economy grew at an annual rate of 4.9%; the industrial countries achieved 4.4%, Latin America, Asia and Oceania a higher rate. Inflation was a little above 3% in the industrial countries and less than 5% in the world as a whole.

The economic devastation of the Great Depression had undermined the classical vision of the economy based on the hypothesis of equilibrium, in which the action of policy-makers was constrained by the rigid rules of the gold standard. Following Keynes, in the new monetary order economic policies were assigned a pre-eminent role in governing the cycle. Controls were imposed on capital movements to permit interest rates to be managed in pursuit of domestic objectives.

The liberalisation of trade contrasted with a segmentation of the market for savings and financial assets on a national basis. Current account imbalances were to be promptly corrected by means of a fiscal policy serving to re-establish the equality between saving and investment.

The system broke down in August 1971, with the suspension of the dollar's convertibility into gold. The main cause of the crisis lay in the US budget and balance-of-payments deficits, which generated an overhang that was incompatible with the dollar's role of anchor. Other factors included economic policies in most countries focused primarily on domestic growth and employment, the rise in public expenditure in relation to GDP, the emergence of international financial markets and increasingly large flows of hot money, which reduced the effectiveness of the restrictions on capital movements.

In a situation where monetary policies were still concerned with the control of interest rates rather than credit flows and the quantity of money, floating rates ended up by fostering an increase in inflation in the industrial countries and in the rest of the world. Monetary growth in the leading industrial countries continued, at an annual rate of 13%. The oil crisis had an impact that was simultaneously inflationary and recessionary.

The growth rate of the industrial countries slowed to around 2.5% in the years from 1973 to 1980, inflation accelerated to 10%. Except in Germany, where monetary policy was directed with greater determination to controlling inflation, the 1970s were marked by high negative real interest rates.

The shift in US monetary policy introduced by Paul Volcker in 1979 gave priority to controlling the quantities of credit and money; interest rates rose sharply to well above the inflation rate. The upward movement spread to all the other leading countries.

1. Global finance

During the 1980s flexibility of the exchange rates between the main economic regions of the world was accompanied by the dismantling of the barriers to capital movements. Growth in the industrial countries was no more rapid than in the previous decade; it slowed in the 1990s.

The persistence of budget deficits and large external imbalances, the rapid advances in data processing and telecommunications, financial innovation and the activity of institutions that collect and invest savings on a world scale all contributed to the creation of a single, global market for currencies and finance. The harbinger of this development was the growth of the Eurodollar market, which had been boosted in the 1970s by the recycling of the surpluses of the oil-producing countries.

The new conditions made it possible for countries to adopt a gradualist approach to correcting budget and, above all, external deficits; it was no longer necessary for saving to equal investment in any given period.

The global market was fuelled by the steady accumulation of external debt by the United States and the build-up of a net credit position by Germany and Japan. In all the leading industrial countries except the United Kingdom public debt continued to rise in relation to GDP.

Gross financial assets and liabilities continued to grow much more rapidly than economic activity. Between 1982 and 1995 the total liabilities of the six largest industrial countries rose from US$ 25 trillion to US$ 110 trillion and from four to six times their GDP. Over the same period the degree of financial integration increased; today, external liabilities are equal to 60% of GDP. The growth in foreign exchange trading proceeded apace.

Favourable investment opportunities encouraged huge flows of capital into the emerging economies; high rates of economic growth were often coupled with large balance-of-payments deficits and stable exchange rates. Foreign investment in these markets increased from US$ 50 billion in 1990 to US$ 200 billion in 1995.

In the OECD countries the assets managed by institutional investors rose over the same period from US$ 14 trillion to US$ 23 trillion and from 85 to 102% of the area’s GDP. These intermediaries manage portfolios that tend to be global and take on technically complex risks. They can modify the composition of their assets extremely rapidly even for the sake of making small gains; they exploit the arbitrage opportunities stemming from fiscal segmentation or price differences between different financial centres.

2. Efficiency and stability

Savings are now freer to flow towards what investors consider the most profitable investment opportunities. This results in a more efficient allocation of the resources available, support for capital formation and better growth prospects, especially for backward economies.

The increase in lending to the developing countries, where the return on capital is higher, is certainly evidence of the markets’ efficiency; on the other hand it brings with it the problem of the sustainability of these countries’ foreign debt and the associated risks for stability, including that of the international financial system.

The Mexico crisis and that still open in South-East Asia, like the debt crisis of the early 1980s in Latin America, have shown that a large inflow of funds can temporarily prop up unsustainable economic conditions. Anchoring the national currency to strong currencies when economic policies are inadequate causes the real exchange rate to rise, creating the conditions for a crisis. Insufficient supervision of banks and markets is a contributory factor.

The liquidity of markets, the belief that securities can be sold without incurring substantial losses can lead to an erroneous perception of the risk. Widespread expectations that the international organisations will intervene can accentuate behaviour on the part of intermediaries that is not consistent with the riskiness of investments.

It is becoming increasingly important to ensure sound and orderly economic conditions and at the same time to strengthen and enhance the effectiveness of the supervision of intermediaries and markets at the supranational as well as the national level, with the aim of forestalling systemic crises.

The restrictive monetary policies adopted in the industrial countries brought annual inflation down from 10% in the 1970s to 5.8% in the 1980s. In the 1990s the objectives have become more ambitious; inflation has fallen further, to an average of 3.1%. Prices have also slowed down considerably in the last three years in the countries of eastern Europe and above all in Latin America.

Real interest rates rose substantially in the industrial countries in the 1980s and 1990s. They increased by around 6 percentage points in the early 1980s in response to the change in the focus of US monetary policy. Real long-term rates stood at about 5% in the first half of the 1980s. Today, excluding Japan, they still stand at around 4%, above the rate of economic growth.

The high level of real interest rates is a reflection of the high returns that can be earned on investments in the emerging countries and the growing risks of a financial nature, which, even though they originate in national markets, affect the whole system. To an even greater extent, with the money supply constant or even slightly declining in relation to GDP as a consequence of rigorous monetary policies, real interest rates are influenced by the rapid growth in the volume of private and, above all, public sector securities.

The ratio of the quantity of money to nominal output has held steady or fallen a little in the leading countries in the 1990s; in 1996 it stood at about 64%. After rising sharply in the 1980s, international liquidity as measured by cross-border deposits has remained virtually unchanged.

For the private sector to acquire the growing stock of financial assets, real interest rates have to be high; the growth in public debt, due first and foremost to the imbalances in social security systems, is a source of pressure on real resources. The gap between interest rates and economic growth rates is a cause of rising unemployment.

3. Italy’s role in international finance

In the course of the 1990s, with the complete liberalisation of capital movements, Italy has become a full participant in the international financial markets. Gross capital inflows and outflows have increased enormously. This process has sustained the accumulation of financial assets and encouraged residents to diversify their portfolios by type of instrument, country of issue and currency of denomination.

Between 1990 and 1996 net portfolio investment abroad by the private sector amounted to 190 trillion lire, accounting for 9% of the growth in total financial assets. The share of foreign instruments in the total financial assets of the private sector rose from 6% at the end of 1989 to 14% at the end of 1996.

The growing flow of savings invested abroad also reflects a domestic supply of financial instruments that is still not sufficiently diversified in terms of risks and returns.

Italy's participation in the global market of finance has encouraged foreign capital inflows, mainly directed towards the government securities market. At the end of last year non-residents held 370 trillion lire of Italian government securities or 20% of the total amount outstanding, compared with 4% at the end of the 1980s.

When doubts have emerged about the soundness of economic policy, foreign capital inflows have ceased suddenly and given way to outflows, supplemented by substantial exports of Italian capital. In late 1992 and again in early 1995 non-residents disposed of very large quantities of Italian securities; at the same time residents' purchases of foreign financial assets increased considerably.

These outflows put the lira and securities prices under very heavy pressure. The reaffirmation of monetary policy's counter-inflationary commitment, the continuation, albeit with pauses, of the efforts to adjust the public finances, and the policy of wage moderation were decisive in easing the pressure and restoring conditions for a stable inflow of capital from abroad.

Looking ahead to a situation of recovery in economic activity and a reduction in the external current account surplus, the diversification of residents' financial portfolios will not put pressure on the exchange rate if non-residents continue to buy large amounts of Italian securities.

During the current year, characterised by favourable expectations regarding the Italian economy and the prospects for Economic and Monetary Union, non-residents' purchases of government securities, totalling more than 80 trillion lire up to September, have contributed to the sharp contraction in the long-term interest rate differential between Italy and the countries with a longer record of price stability and a lower level of public debt. Exports of Italian capital have also increased, however.

One of the reasons for the gradualness with which monetary policy has been eased has been to ensure favourable conditions for foreign investment in Italy, taking into account the continual, structural outflow of Italian capital.

As Economic and Monetary Union draws closer and national monetary policy's room for manoeuvre gradually narrows to the point of disappearing, the macroeconomic equilibrium of each country will come to depend increasingly on budgetary, incomes and structural policies. In the absence of changes in the relative values of currencies, imbalances will impinge on competitiveness, production and employment.

Public spending in Italy is now equal to more than 50% of GDP. Reducing this ratio will make it possible to ease the burden of taxation and social security contributions. In order to enhance Italy's competitiveness and reduce the cost of labour, it is also necessary to remove the obstacles hindering competition in the markets for goods and arrive at a more flexible use of labour.

4. Concluding remarks

In addition to benefiting the participating countries, the creation of a stable monetary area in Europe will contribute to the stability of the real and financial macroeconomy at the world level.

In recent years Europe has been beset by modest growth and insufficient use of available resources; between 1990 and 1996 employment declined by 2 million units. Adverse factors include inefficiencies in some parts of the productive system, market rigidities and excessively large budgets.

The implementation of a closer economic union and the soundness of money and finance over time cannot be entrusted exclusively to monetary policy. They require conditions of greater economic efficiency and the harmonisation of institutional arrangements in the participating countries.

A sound currency requires a dynamic economy. Money is largely the product of the credit granted to firms and the State. The stability of its value does not depend only on the quantity in circulation but also on the efficient use of credit.

Economic convergence must therefore be pursued not only in the nominal variables but also in labour productivity, a level of taxation that will enhance international competitiveness, and an efficient use of the resources the public sector appropriates. These are the conditions for a monetary union to have the necessary stability and solidity.

The global market for currencies and finance influences the performance of all economies. The conditions in that market increasingly appear as exogenous variables of decisive importance. The macroeconomic equilibria of individual economies have to be related to the level and movements of interest rates determined in it and to the exchange rates established there between the leading currencies.

The external constraint is increasingly taking the form of the need for each country and economic region to be in overall balance, in terms of financial assets and liabilities, with respect to the rest of the world.

The development of the global financial market in the last ten years parallels that of national financial markets in the later nineteenth century and the first half of this century. The increase in financial activity within each national market, the expansion of credit and the development of intermediaries all made a decisive contribution to investment, production and employment. But the need rapidly emerged for overall control of money creation and even earlier for a system of prudential supervision of intermediaries' activities. Today's central banks are the result.

At the international level the expansion in the nominal amounts of credit and money has no longer been limited by the availability of primary liquidity since the link with gold was broken. The present configuration of the market has evolved spontaneously, largely in conditions of fierce competition. However, given the nature of the variables involved, it is unlikely that a Pareto-efficient equilibrium will be reached.

Money produces credit and credit produces more money; it is necessary to govern the growth of these aggregates; an anchor is needed to stabilise their value in terms of goods. In the absence of binding rules and appropriate policies, national economies and the international economy are exposed to the risks of inflation and instability in intermediaries and markets.

This inflationary drift is likely to lead to speculative bubbles, excessive increases in the value of real and financial assets. The international crises that occur from time to time diminish the value of financial wealth and curb inflationary pressures at the world level.

With many economies suffering from stagnation and poor fundamentals, the low cost and rapid expansion of dollar financing in the early 1990s and the subsequent restriction, together with the more recent monetary expansion in Japan and loss of value of the yen, have probably contributed to the instability of the global market for finance.

The efforts, redoubled in recent years, to achieve monetary stability in most of the industrial countries, the banking supervision started by the Group of Ten for developed countries, its extension to the emerging countries and the surveillance performed by the IMF are playing a role of great systemic importance.

Faced with open and competitive markets, the strengthening of cooperation helps to forestall crises, increases the efficacy of corrective action. Effective action by central banks, supervisory authorities and the IMF is a first response to the new problems of monetary and financial stability raised by the globalisation of markets; it may require more certain and firmly based international institutional arrangements.