Mr. Bäckstrom discusses the economic situation in Sweden Speech by the Governor of the Bank of Sweden, Mr. Urban Bäckström, at a seminar organised by The Swedish Shareholders Association, held in Malmö on 10/10/98.

First of all I should like to express my thanks for the invitation to visit Malmö to discuss the economic situation. A major phenomenon in the current economic situation is, of course, the international financial turbulence. The crisis in the Japanese economy has been developing throughout the 1990s and the problems in Asia as a whole are now in their second year. The Asian crisis, which is having widespread real economic repercussions in that region, has in turn accentuated the problems in Russia and, to some extent, in Latin America, with associated contagious effects in Western financial markets. Stock exchanges have fallen around the world and some players in the financial markets have incurred losses.

This in turn raises a number of questions about the global economic trend. How negative may the real economic effects become in the United States and Europe? What part are the central banks playing? The US Federal Reserve has recently lowered its instrumental rate and so have other central banks. Will that affect the Riksbank's actions? Matters to do with world economic development and what should be done - not just to mitigate the short-run effects but also to construct systems and institutions so that similar events can be avoided in the future - have been high on the agenda for economic policy discussions in various fora this autumn. The latest instance is the 1998 Annual Meeting of the International Monetary Fund in Washington D.C. earlier this week. In connection with that meeting, finance ministers and central bank governors from all over the world assembled in various groups to discuss the situation.

Background to the global economic problems

Just a year or so ago, many observers foresaw a golden future for the world economy. There was talk in some places of a new economic era, with strong growth and permanently low inflation, at least in the United States. Today, the discussion has shifted in general to deliberations about the risks of a world economic slowdown. The challenges the global economy is facing at present are a combined result of several factors. One of these factors is, of course, the situation in Japan, where the economic problems, as I just said, have been at work throughout this decade. The inability to take sufficiently resolute action has led the Japanese economy into a serious decline. Japan has the world's second largest economy and is of primary importance for the outlook in Asia as a whole.

A crisis in other Asian countries then materialised almost a year ago. The problems showed up first in Thailand but soon spread to South Korea, Malaysia and Indonesia. While the deterioration in these countries was partly a consequence of the economic stagnation in Japan, perhaps the main cause of the acute crisis was that a strong capital inflow from the West, above all from the United States, suddenly turned into an outflow. For various reasons, political as well as economic, assessments of the development potential in the countries in question had been gradually revised.

More recently the problems have spread to Russia, where the economic situation - as in Japan - was already troublesome. The situation became so precarious that the Russian government suspended payments on government debt denominated in the domestic currency. That was a very far-reaching decision. Since then, capital outflows have also hit Latin America. For a long time it seemed that the Asian crisis would not have sizeable repercussions in industrialised countries in the West. The direct real economic impact was judged to be small and at first it looked as though the main effect would be a tendency to keep inflation down, while growth would remain good. As Russia also encountered increasing problems, however, there was growing concern and the crisis accordingly began to spread even to financial markets in the West. During the summer, share prices began to fall. Credit risks rose. Investors and banks started to become increasingly cautious, partly on account of some losses. When a highly reputable hedge fund, Long-Term Capital Management, was hit by major setbacks, the international banks became even more wary.

Investors have fled to assets that are generally regarded as secure. Lending rates to all but the most creditworthy borrowers have therefore risen around the world. In the last few days, moreover, long bond rates have moved up in many countries, which is a sign that investors are increasing the cash component of their portfolios. Expressions like “flight to quality” and “flight to cash” are common in the course of a development such as that we are now experiencing.

How great will the repercussions be?

Observers throughout the world are now engaged in appraising the global economic effects of the crisis in Southeast Asia, the inability to tackle the problems in the Japanese economy, the uncertainty about the situation in Russia and the risk of contagious effects in Latin America.

The world economic impact of the problems in the emerging markets can be divided into effects on real economic activity and influences via financial markets. The latter are transmitted both by falling prices for shares and possibly other assets and by a higher degree of prudence on the part of firms, households and banks.

Let me begin with the real economic effects. In the emerging economies that are currently affected, the problems have led to sharply falling demand and output. Imports from the rest of the world are therefore declining, too. At the same time, currency depreciation has improved the competitiveness of exports. Thus, a weakening of Western exports to the emerging markets is being accompanied by a gradual increase in Western imports from these countries. For overall growth in the OECD area, however, the aggregate real economic effects are probably not all that large.

So what about the effects transmitted by financial markets in the West? A falling stock exchange reduces the value of households’ share portfolios, which may influence the propensity to consume. It also increases the cost of capital procurement, which may likewise affect demand via a weaker propensity to invest. The recent global fall in share prices - more or less wiping out the increase in the past two years or so - should be seen in the light of the strong upward trend that share prices have followed in the 1990s. In Sweden the OMX Index is still around 300 per cent above the low in the autumn of 1992. In the United States the Dow Jones Index is about 200 per cent higher than at the beginning of 1991. This provides a perspective for the impact of falling share prices on international growth. It should also be borne in mind that the US economy is more sensitive than Europe to a falling stock exchange.

When it comes to confidence, it is more difficult both to quantify and to arrive at more definite conclusions about consequences of the crisis. We do not know to what extent the present course of events is affecting how households and firms appraise both their own and their country’s economy. A good many people and businesses will no doubt become more cautious about buying a car or making investments for the future, for example. Here we have a potentially larger effect that must be monitored very carefully. Some guidance is to be had from various countries’ survey data. A number of the results point to a fall in consumer confidence.

Neither can one draw any precise conclusions about the magnitude of the effect that may come from increased prudence in banking around the world. The global unrest has left its mark. No one foresaw that Malaysia would introduce foreign exchange controls. Nor did any banker believe that Russia would go so far as to suspend payments on debt denominated in roubles. People seem to be thinking that if such things could happen in Malaysia and Russia, perhaps they can happen elsewhere.

The problems with the hedge fund Long-Term Capital is another matter that has made international bankers more wary. Although their loans to this fund were secured, the total stock of loans from all banks and the total amount of collateral were too large for direct disposal in the market; that would have caused prices to fall, leading to losses for the banks. Under such circumstances it is hardly surprising that international banks also review their lending commitments to other funds.

The key question is whether the international banks' review of lending commitments will be extended to include other groups of customers. Perhaps their lending policies will become generally more restrictive. One sign of this is that the flow of loans to many countries which are regarded as emerging markets has virtually dried up. The interest rate differential between treasury securities issued by such countries and by the US, for instance, has widened dramatically this autumn. In turbulent times, moreover, banks have difficulty in fulfilling their function, which is highly important in a market system, of distinguishing sound borrowers from others. The result may be that their provision of credit is completely suspended.

It is already evident that in their assessments, various players are tending to disregard more fundamental factors. An example of this is the weakening of the krona. Despite good economic fundamentals in Sweden, since the summer the krona has weakened sharply and last week this tendency accelerated. In a matter of days the exchange rate with the German mark declined by up to 5 per cent. In that situation the Riksbank decided to intervene in the foreign exchange market, which nowadays is unusual. We did so to demonstrate that we considered the krona's fall was excessive in relation to the fundamental state of the economy and that the time had to come to pause and reconsider the situation. Instances of "follow-the-leader" behaviour occur not just in bullish stockmarkets but also in the currency market when many countries with different conditions are lumped together in a general assessment. Market players must assess each country separately. Central bank interventions under certain circumstances are uncommon with a flexible exchange rate regime but they do occur. I cannot exclude the possibility of the Riksbank intervening again if this were to be called for.

Growth in the industrialised countries may thus be affected by the real economic crisis which has hit the emerging markets and resulted in a sharp fall in output there. The magnitude of such an effect will be highly dependent on confidence - confidence among households and firms so that they are prone to consume and invest, confidence among banks so that they are prone to provide credit.

The Riksbank's appraisal

In the Riksbank's most recent Inflation Report we counted on an OECD area growth rate of around 2 per cent in the years ahead. It should be borne in mind that this figure represented the latest in a series of downward revisions over the past twelve months.

Since the publication of the September Report, our assessment of tendencies in the rest of the world has not changed. Considering the mechanisms to which I have just referred, however, it is not surprising that our Report highlighted the risks associated with the external situation. This situation is unusually difficult to evaluate and has to be followed closely.

In the situation that has arisen, why doesn't the Riksbank lower the repo rate? After all, other central banks have done so.

The answer is that our assessment includes all the factors which have a bearing on developments in Sweden and future inflation. To date in 1998, economic development in Sweden has been very good. At present, moreover, it is very difficult to foresee the krona's future path. As I mentioned earlier, the economic fundamentals point to a definite appreciation. If that is not sufficiently marked, however, export production will be strongly stimulated. It is difficult to tell whether that in turn would alter inflation prospects for the period of twelve to twenty-four months that is relevant for monetary policy. That is something to which we will be returning when the international picture becomes clearer. It is also a consideration that has to be weighed in with the outlook for the domestic economy. A repo rate cut is not topical in Sweden at present.

How did it happen?

Why is it that the unrest in Southeast Asia and Russia, with some tendencies to spread to Latin America, is beginning to affect the financial system in the industrialised countries? What has gone wrong in the global financial system?

There is no simple answer to these questions. But let me briefly mention a couple of factors. First, however, it is important to underscore the advantages that accrue from a global financial system of the type that has been developed in the past decade. The countries which participate in the international capital market tend to have higher per capita growth rates than other countries. The globalisation of production and trade calls for new solutions for payments and financing. It is also a great advantage to have a financial system that is capable of channelling savings to those parts of the world that need them most for investment.

However, participation in the international capital market presupposes that a country has an adequate banking system with accounting regulations and other institutions, such as thorough supervision that ensures sound banking practices. This has evidently not been the case in a number of the countries that are now affected by the crisis. Nor should we forget that the banking system in Sweden was not fully prepared at the time when our credit market was deregulated.

If loans from the international capital market are channelled to a country where the banking system and other financial institutions are not ready to function in this community, the result may thus be loan losses. But, as you know, it takes two to tango. It may well be asked why banks in the industrialised countries have arranged loans to countries that evidently were not yet sufficiently sound borrowers. Capital has been flowing to emerging markets in a broad stream in recent years. It has been channelled directly through the banks as well as indirectly, for instance via hedge funds. A good many such funds have obtained large loans from banks in the industrialised countries and, in pursuit of favourable yields, invested the money in emerging markets. This indirect lending can be likened to the Swedish banks' earlier lending to finance companies.

This brings us to the nature of banking in a more profound sense. Traditional banking involves accepting deposits from the non-bank public and lending these funds to various borrowers. Moreover, the equity capital on which banking is based is small, which implies high leverage and low solvency.

If all the banks' capital had consisted instead of equity, incurred losses could have been handled more or less painlessly. With a large proportion of borrowed capital, however, there are liable to be chain reactions that successively spread through the banking system. It is precisely this that necessitates comprehensive, efficient supervision and a functional set of regulations in order to avoid unnecessary losses. That is also why central banks around the world have been assigned the function of safeguarding the financial system's general stability.

What can be done?

The current problems in the global financial system need solutions for both the short and the longer run. In the short run it is a question of resolving the acute crises. Work for the longer run must focus on the creation of an international rule system that prevents crises of this type from occurring. In the work that has begun on a new architecture for the financial system, measures of three kinds have been singled out as particularly important: more transparent accounting for financial institutions as well as for governments and central banks; a greater involvement of private investors in crisis management; and a reinforcement of the financial system.

For work on the third category, there are in principle two different approaches or a combination of these. One involves tightening up the supervision of banks and the other the introduction of higher capital standards to raise the proportion of equity capital in the bank sector. My guess is that the future work to create a more functional banking system will be conducted along both these approaches.

In the prevailing situation it is important that the international banks do not become unduly cautious. Banks should take risks but their risk-taking should be properly managed. It would be unfortunate if more countries were to start imposing restrictions on capital exports. That would exacerbate the present state of affairs. Similarly, it would be directly counterproductive to introduce some type of turnover tax, as proposed earlier by Professor James Tobin. That was tried out in Sweden in the late 1980s and simply resulted in trading being transferred to other countries. Even if agreements were to be reached between many countries, there would always be countries that refrained from joining the arrangement. Moreover, the poorer liquidity that would accompany turnover taxes might actually impair the workings of some financial markets. New regulations may simply do more harm in the present situation. But the players in international financial markets do need to review their systems for evaluating risks. Risk assessments based on historically determined correlations between different assets may be inadequate when earlier patterns are broken and the supply of liquidity changes.

In the short run the problems in the global economy must be solved at their origins. Via the International Monetary Fund, in certain situations the international community can contribute liquidity if the countries in question are prepared to take measures. It is, indeed, an enigma that the world's second biggest economy, Japan, has not managed, year after year, to tackle the problems in its banking system. Economic development in Japan is highly important, not least for other countries in the region. All observers are agreed that the problems in the banking sector must be rectified. Fiscal measures are also called for. Nor would I rule out the introduction, as part of a stability programme, of a numerical inflation target that might help to modify the negative expectations. It is my hope that the current signals about future measures will be fulfilled.

The US Federal Reserve is also strongly focused on the problems in the global economy. In Europe the action of central banks will be determined by the extent to which Europe is affected by what is now happening. To date, however, it looks as though Europe is moving in the right direction.

The Riksbank, too, is keeping a close watch on the financial system's stability. In times of financial unrest, such as recently, the Riksbank steps up its oversight as a matter of routine, above all as regards financial enterprises. If problems were to arise with bank liquidity, for instance, they would create difficulties not only for monetary policy, in that the interbank market would function less well, but also for other parts of Sweden's economy. The Riksbank therefore monitors the potential effects that financial unrest could have on the financial sector's solvency and liquidity.

The analysis of the situation is supplemented with an ongoing exchange of information with the competent authorities in this field. Stockmarket unrest of this kind also leads to heightened surveillance of the flow of payments in the Riksbank's payment system, RIX.

Judging from the available statistics, the Swedish banks are in a better position than many of the international banks, with lower direct exposures to the countries involved in the crisis. Perhaps one could say that Sweden's bank crisis did at least result in Swedish banks becoming much more efficient at risk management.

Central banks throughout the world have accordingly become more watchful. No one can remain passive if world economic growth continues to slacken as a consequence of financial problems.