**Mr Stark discusses the worldwide currency situation and international monetary cooperation**

Speech by the Deputy Governor of the Deutsche Bundesbank, Dr Jürgen Stark, to ELEC in Kronberg on 4/12/98.

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I

Anyone comparing the global economic policy debate at the end of 1998 with the debate last year will notice not only a number of similarities but also some striking differences.

It is true that there was already a debate under way at that time on the crises of some countries in South-East Asia. In fact, President Tietmeyer spoke in depth about them to ELEC pointing out potential domino effects.

A general optimism prevailed in the public debate, however, particularly in respect of future developments in the US economy. At all events, I can well recall headlines announcing the 'end of the business cycle' and predicting the arrival of the 'new economics', which probably referred to the theory of continuing progress in productivity or even the end of the economic problem of supply and demand itself.

Quite often, it is the same commentators who only a few weeks ago were forecasting a 'global economic crisis' with a similar supposed degree of certainty and evoking the start of a world recession. Two months ago – at the Annual Meetings of the IMF and the World Bank – talk was still of 'doom and gloom'. But today we can read again headlines like 'Crisis, what crisis?'

However, a return to the Garden of Eden and the decline of the old world are events that tend not to happen very often. At all events, we are still alive.

The fact that people fail to strike a balance between optimism and pessimism was pointed out recently by the US economist Paul Romer, one of those talented people in his profession who are wrongly claimed to be proponents of the 'new economics'.

One cannot escape the feeling that one-sided and exaggerated perceptions are contributing to the present problems of the global economy. Do they not create sentiment and expectations that tend to strengthen rather than reduce the much lamented herd behaviour of the markets?

Anyway, the transparency of opinions about supposed facts stands in sharp contrast to the transparency of the facts themselves. The media and the markets produce and process information incessantly. The question is whether it is the relevant information. If that were the case, there would scarcely be an international debate on improving transparency in the financial markets.

II

Certainly, a 'worst case scenario' can never be completely ruled out in theory, although a scenario of that kind depends on the interaction of a large number of factors.

*Keyword ‘accumulation of slumping economic cycles’*

A number of Asian economies are indeed going through a sharp recession at present. Japan, as one of the largest economies in the world, has been suffering for quite some time from a negative business trend and a crisis of confidence caused by structural problems in the financial sector.

In August, the developments in Russia added to the crisis in the Asian countries. The unilateral moratorium led to a reassessment by investors of the risks in other emerging markets, such as of Latin America.

These factors have contributed to a shift in global expectations of growth, which vary quite considerably from region to region.

On the other hand, the fact cannot be ignored that some countries, in particular in South-East Asia, are showing initial successes in overcoming their internal structural problems. In a number of cases, they have been able to stabilise their exchange rates and, in some instances, have witnessed an appreciation of their currencies enabling some countries to reduce their interest rates again.

Of the greatest importance for the region is the situation in Japan. Initial steps have been taken to eliminate the structural problems in the financial sector by adopting the Financial System Revitalisation bills. Now it is most important to implement those measures in a consistent and convincing manner.

What mainly argues against a ‘looming global economic crisis’ is the economic situation in the United States and Europe.

Despite a slight drop in pace, the US economy seems to be in relatively good shape overall.

Admittedly, the structural problems should not be taken too lightly there either. The savings ratio of households has shown a continuous fall over the past few months. In September, it was negative for the first time. That is related with the high and increasing current account deficit which can only be financed by extensive capital imports.

In the future euro countries, economic growth up to now has been strong, although some forecasts for 1999 were revised downwards recently. A temporary slowdown is expected.

But all in all, it is scarcely adequate to speak of an accumulation of slumping economic cycles.

*Keyword ‘deflation’*

Despite all the dire predictions, there are no indications worldwide of deflation either. At any rate, there is no evidence of a cumulative decline in the general price level and an associated, self-intensifying contraction of economic activity either in the European or the global context.

What we are witnessing at present in Europe is a process of disinflation. In part, this is being fostered by international developments in the prices of commodities and crude oil – incidentally, with quite positive terms of trade effects for the oil-importing euro countries.

In Germany, for example, core inflation is about 1%.

‘Deflation is not on the agenda,’ Stanley Fischer, the IMF’s Deputy Managing Director, recently underlined. The present price stability and the low level of interest rates in the capital market indicate the absence of inflation expectations. That provides the opportunity for longer-term inflation-free growth.

III

If it appears rather unlikely that the crises in parts of the world economy will spread to America and Europe through the real economy, is it not possible – given a loss in confidence – that this could happen through the channel of the financial markets?

*Keyword ‘credit crunch’*

A number of observers fear, for example, that the current uncertainties in the financial markets might cause financial institutions to refuse financial resources even to first class borrowers in future – with matching implications for investment and growth.

There would be various reasons for that:

- First, financial institutions change their risk preferences, especially as a result of disappointed confidence or an expected recession. At least for a while, there may be a higher risk aversion overall.
- Second, financial institutions find themselves subjected to an erosion of their capital base. They then have to show restraint in terms of further exposures – even to top-rated borrowers – in order to restore appropriate financial ratios. A rise in the cost of equity can even reinforce that.
- Third, the assets deposited as collateral decline in value, say, as a result of a fall in asset prices in the real property or equity markets.

In some cases, however, what is worrying about a credit crunch is the idea that the normal price mechanism balancing supply and demand is being paralysed in the credit market for specific reasons.

In a ‘credit crunch’ scenario – so the theory goes – financial institutions do not respond to a rise in demand for credit by raising the lending rate and extending their supply of credit.

That is because they fear a disproportionate rise in the share of demanders of credit with comparatively risky projects – the keyword is ‘adverse selection’. Moreover, after receiving credit, the debtors would have an incentive to enter greater risks – the keyword is ‘moral hazard’.

If banks have difficulty in assessing their potential borrowers’ risk and are unable to monitor the behaviour of their debtors perfectly, they tend to refuse to grant credit, especially in a situation of economic uncertainty.

Furthermore, the problem of ‘asymmetric information’ cannot be solved by the provision of collateral. If there is a fall in asset prices – say, with the bursting of speculative bubbles – the value of the collateral provided will undergo a dramatic fall.

How relevant are such considerations to the present global economic situation?

A more in-depth view is probably needed here, too – in particular as it is difficult to identify a credit crunch in a clear-cut manner. It is not possible to identify whether a decline in lending is due to a restraint in supply or to slack demand.

Despite these problems in the diagnosis, there are some indications in Japan of a credit crunch on the supply side. That is suggested, at all events, by the inadequate capital position of a number of Japanese banks. Even established corporations seem to be receiving scarcely any more loans.

We do not have a problem of liquidity supply worldwide, however. What we do have is a confidence problem which is being manifested in a generally greater risk aversion.

In the United States, credit terms have worsened since the summer, especially as a result of the turbulent developments in the equity markets. However, with its cuts in interest rates the Federal Reserve Bank has – so far successfully – prevented a credit crunch.

In the countries forming the future euro area, there has so far been no evidence of a credit crunch. There is no identifiable reduced lending, nor have the banks' capital bases been eroded by large-scale losses.

Even the argument that continental European banks are at risk as a result of their relatively large exposure in the countries of central and eastern Europe is putting things too simply. First, the banks have entered short-term exposures only on a minor scale. The major part of their lending has a medium- and longer-term maturity and is secured by Federal guarantee.

Second, the off-balance-sheet positions which are not shown in the statistics are of particular importance for assessing the degree of risk to which the financial institutions are exposed. In that respect, I feel that European banks bear less of a burden.

Overall, the effects of the regional crises on the real economy are weaker, too, in Europe, and the financial system is, on the whole, more stable. That is probably due to the difference in financing arrangements.

In the United States, for example, financing is mainly taken up through the market. By contrast, in Europe there is much more direct financing through individual (house) banks. Another factor is that credit risks can be intercepted better in the continental universal banking system.

Given the slight fluctuations in property prices, slumps in credit resulting from dwindling collateral are also unlikely here.

## IV

*The keyword 'contagion'* undoubtedly belongs on the agenda, too.

The worldwide potential for contagion has certainly increased over the past few decades, although it is always difficult to draw a clear dividing line between contagion effects and shortcomings in policy.

The individual economies are becoming increasingly integrated internationally. Above all, the rapid dismantling of restrictions in foreign exchange and financial transactions has brought the markets closer together. And increasing securitisation and the marketability of assets make the individual debt relationships anonymous.

Finally completely new conditions have been created by enormous technological progress and all-pervasive computerisation in the financial markets.

Institutional investors, investment funds or insurance companies can move large investment amounts from one country to another and change them from one currency into the next within a few seconds.

Certainly, there has been an enormous increase in the opportunities of investing funds in a country. But there are also greater opportunities of withdrawing those funds with all of the adverse implications for the exchange rate and the domestic real economy.

In that way, financial flows rove around the globe in search of profitable investment opportunities.

However, that is by no means as negative as it is often presented. Admittedly, this calls for discipline from policymakers and from the market players.

Access to the international financial markets has allowed many former developing countries and emerging economies to develop quickly and has improved their living standards.

But these developments naturally also harbour risks.

Profit margins have fallen under rising competitive pressure. Turnover-oriented transaction-driven finance is displacing traditional buy-and-hold finance.

Longer-term bilateral financial relationships between banks and enterprises, which are typical of continental Europe, are being increasingly replaced by Anglo-Saxon financing through the markets. That also means a growth in short-termism. Volatility in the markets becomes greater.

Given the low level to which interest rates have fallen in the capital market during the past few years in industrial countries, there has probably been a rise in the general willingness to take risks in order to be able to offer domestic investors the yields on their investment that they have been used to.

Confidence in the newly developed hedging opportunities has also encouraged riskier investment. Until recently, some investors evidently regarded the hedge funds they used as a kind of fully comprehensive cover.

The predominance of institutional investors has, at the same time, fostered a kind of herd instinct.

Large-scale investors can afford to make a solid review of their investment in regions that are prone to risk. But many smaller investors act as ‘free riders’. They save themselves the trouble and cost of their own research and gear their investment to that of the large-scale investors. If large-scale investors withdraw their funds from a country, many other investors follow almost without any examination. Incidentally, that does not mean that the large-scale investors have adequately identified the risks in the past.

As a result, however, the fundamental differences between individual investments or the countries concerned are obscured. There is an increased risk that the ‘herd’ of investors will break out in a blind stampede in times of uncertainty.

As certain as it is that the possibilities of contagion are greater, it is just as impossible to identify and isolate a clear transmission path for crises.

Several factors seem to play a role, such as a similar macroeconomic situation, a high level of government debt or even similar exchange rate systems.

There is no doubt that countries are susceptible to crises if political conditions there are unstable and contribute to international investors' uncertainty.

What is crucial, however, is that fundamentals in the countries concerned appear to play a much greater role overall than the international capital movements and the volatility in the financial markets which are everywhere alleged to be the cause.

In South-East Asia, for example, it was mainly the lack of operationally efficient banking supervision which led to a rapid expansion of credit.

On the banks' assets side were longer-term assets in domestic currency, such as shares and loans for real estate projects. On the liabilities side were what tended to be shorter-term issues and liabilities denominated in foreign currency.

This meant that the banks were vulnerable in two ways: first, to asset price bubbles bursting and, second, to depreciations of the domestic currency.

When confidence in the dollar pegs actually did diminish, the banks came under massive pressure. The fragile domestic financial sector collapsed like a house of cards.

How then is it possible to make a further reduction in financial market instability and in the present risk of contagion spreading from South-East Asia to other regions?

V

What is important for that is how things develop in the expectation-biased financial markets. At present, they probably still lack clear orientations, which is reflected by a level of volatility which is still high.

In the present situation, clear economic policy signals are therefore of paramount importance. Above all, the confidence of the markets has to be restored.

Only underlying economic and political conditions that inspire confidence nationally and internationally can lay the basis for long-term involvement by foreign investors and for stable financial relationships.

That is of structural importance. It will also make it possible to get away globally from the overemphasis on short-term financial flows and the associated short-termism.

First of all, it is Japan that has to act. The confidence of the general public and the markets in Japan and, in the long term, in the region can be restored only if the reorganisation of the banking sector is pursued in a determined manner.

The emerging markets affected by capital outflows naturally also have to act. They, too, must solve their internal structural problems. Such solutions should be geared to the principles of a

market economy. In the long term, sliding back into a protectionist policy does most damage to the country which seeks to isolate itself.

Payment moratoria and capital controls that are unexpectedly introduced ex post and forbid investors to withdraw their funds may lead to a locking-in. They are damaging for international confidence and increase the risk of contagion.

What deserves main attention is the establishment of efficient banking and financial market supervision in accordance with international standards. That includes setting up adequate safety nets for private bank deposits – perhaps in the form of a deposit guarantee fund – in order to prevent a run on the domestic banking system in a crisis.

The international financial markets also need certainty about the role of the central banks. Internal stability should take precedence over defending unrealistic exchange rate pegs.

Certainly, a prudent monetary policy will always leave sufficient scope for economic growth. But the central bank must not foster lending booms and speculative bubbles by pursuing a policy of easy money.

It is, above all, also the IMF which bears responsibility as the leading international financial institution.

Possibly the IMF has dulled private investors' risk awareness and encouraged 'moral hazard' behaviour by granting generous financial packages in past crises.

As important as short-term financial assistance is for giving direct support to affected countries that are prepared to reform and for preventing contagion, private investors must not simply be bailed out. Those who enter greater risks in the expectation of higher yields ought also be ready to bear any consequent losses.

The IMF should therefore refocus more on its role as a catalyst for preventing and overcoming crises.

For example, in the latest financial package for Brazil, amounting to US$ 41.5 billion, only around US$ 5 billion comes from the IMF's own resources. By contrast, US$ 27 billion is being raised by what is basically bilateral funding through the facilities of the BIS and the activation of the New Arrangements to Borrow.

The activation of the NAB must not be a model for other cases, however. The NAB are, strictly speaking, a 'reserve tank' for cases of extreme emergency. Activating them is acceptable now only as a 'precautionary' agreement because of Brazil's special role for the stability of the global financial markets.

Funding through the BIS must not become standard practice either. IMF programmes should, as a matter of policy, be funded by the IMF.

Rather than tying up larger financial packages with the aid of other organisations, the IMF should involve private creditors in crisis solutions to a greater extent than hitherto. The IMF should also call for internal structural reforms in the national financial markets.

Above all, the IMF can play a major role in improving the transparency of the international financial markets and thus in dismantling the asymmetrical distribution of information.

That is an aspect which should not be underrated.

If a lack of transparency is among the causes of processes of contagion and herd behaviour and if a credit crunch is ultimately due to asymmetrical information, increased transparency will make a crucial contribution to the stability of the global financial system.

The operational efficiency of the markets will be strengthened; investors will be able to make an appropriate assessment of risks; and the risk of contagion will be significantly reduced.

I would even go one stage further. If the markets do not create optimum transparency themselves, there is much to be said for providing transparency in some cases as a public good as well – by the international community, such as through the IMF, through the G-10 and the supervisory authorities in the national financial markets.

Obviously, transparency belongs on the agenda of international cooperation.

Any approach to international cooperation extending beyond that must not ignore world economic and political realities, however.

That applies, in particular, to any attempt to force exchange rates into a more or less narrow regime.

A global exchange rate system would create major problems. In my view it is neither desirable nor feasible.

First, the differences in the fundamentals of the participating economies are too great. Second, the internally conducted policies are not directed towards the same aims.

Flexible exchange rates are an important safety valve which can take pressure off economic disequilibria. Regulated currency markets, on the other hand, create no more than an illusory stability. Sooner or later that situation might explode.

One of the lessons of the recent crises is: the vast majority – if not all – of the countries affected by the crises had pegged their exchange rates too rigidly.

VI

In the future euro area, the exchange rate safety valve will be irrevocably shut from January 1, 1999.

The financial markets have already accepted the forthcoming monetary union. They regard the announced irrevocable exchange rates of the participating countries as credible. And by yesterday's decision of 10 European national central banks to lower interest rates, it has been demonstrated: we are already in a de facto monetary union.

The euro has undoubtedly already passed its first severe test during the financial market turbulence of the past few months.

But that success is based on many years' efforts to achieve convergence. It is the outcome of setting priorities: the priority of internal monetary stability and the priority of consolidating government budgets in the participating countries.

However, that stability-oriented policy mix must also be retained in future, because the real tests for the euro are still to come.

In future, there will only be a single monetary policy, on the same terms and conditions, and at the same interest rates, in all participating countries. Adjustments to differing regional trends must take place regionally and in the real economy in future.

Regional competitiveness and a high degree of internal flexibility will then become crucial assets of national economic, fiscal, wage and social policies.

This is the new reality to which all participating countries must adapt. The sooner, the better. Only then can the euro be a success and play its part in helping to stabilise the international financial markets.