IX. Conclusion: stable prices but changing financial structures

The world shows some signs of having become a less inflationary place. In most European countries and in Japan, inflation last year either reached, or was maintained at, very low levels. In the United States, continued strong growth in the sixth year of expansion was possible only because of the absence of resurgent inflationary pressures. Moreover, outside the industrial world, many countries made dramatic progress in reducing inflation further. A variety of causes can be suggested for this phenomenon: technological progress and the sharp fall in the price of data-processing and telecommunications equipment, globalisation due both to trade and to foreign direct investment, and retrenchment following earlier periods of excessive spending. None of these forces seems likely to dissipate soon. Furthermore, the level of unemployment, whether measured or hidden, remains very high in most countries and needed structural and regulatory reforms could increase it even further in the short run. Finally, government expenditure in most industrial countries must also remain restrained, not only to cope with excessive levels of government debt, but also to secure the means to provide future pensions and medical care for an ageing population.

These broad-based forces, affecting both supply and demand, imply that inflation should generally be less of a problem in the near future than in earlier decades. Nonetheless, it would be highly imprudent to assume that the laws of economics have changed in any fundamental way. Over time, although fiscal policy can help or hinder, the general level of prices continues to be determined by monetary policy, which has the power to deal with either excessive or insufficient levels of demand. In the United States, the recent tightening of monetary policy indicates a desire to resist the former, whereas in continental Europe and Japan the willingness to accept a further easing of monetary conditions in 1996 points to a judgement that disinflationary forces are still in the ascendant. In many emerging market economies, it is also clear that the principal cause of sharp declines in inflation has been a disciplined monetary policy, often in association with supportive fiscal and exchange rate policies.

Against a backdrop of low or declining inflation, more prudent fiscal policies and a growing commitment almost everywhere to market liberalisation and restructuring, there are good grounds for expecting solid and sustainable growth in the global economy over the next few years. This is currently the consensus view of both public and private forecasters. Moreover, financial markets also seem to be anticipating good news. Equity prices, even after having fallen back in the spring of 1997, still seemed to discount further increases in earnings in many markets. The record flow of capital into emerging markets in 1996, increasingly in the form of bond and equity issues as well as direct investment, suggests expectations of either higher returns or lower risks than previously. In addition, the convergence of bond yields in Europe is consistent with a similar convergence of inflation and fiscal prospects, allied with a growing confidence that the euro will be introduced essentially as planned.

Yet, just as it would be premature to declare inflation dead, it would also be unwise to assume that sound fundamentals guarantee good performance in the near term. In fact, there are identifiable risks to the outlook in each of the major geographical areas. Perhaps the most pressing concern is that inflationary pressures in the United States may prove more difficult to tame than is now anticipated, and that the expansion might eventually end abruptly. Even a "soft landing" which demanded a series of tightening measures might have significant implications for equity prices and other more risky investments. In continental Europe, the principal risks relate to the need for structural reforms, particularly in labour markets, and the possibility of market turbulence in the run-up to economic and monetary union. These risks make it all the more important that European countries seeking to participate in monetary union pursue firm macroeconomic and structural policies, so as to avoid doubts about their eventual participation that might cause domestic interest rates to rise and undermine their fiscal position.

In Japan, obvious concerns are the headwinds arising from continuing weakness in the financial sector and a need for both structural reforms and fiscal restraint which could affect demand in the short run. In many countries in Asia, Latin America and Eastern Europe, which have based their stabilisation strategy on exchange rate anchors, the challenge will be to restore external competitiveness without sacrificing the advances recently made against inflation. The fact that banking systems in many of these countries are quite fragile is clearly another source of uncertainty about the macroeconomic outlook.

To point out these risks is not to challenge the consensus forecast of quickening growth and low inflation: the variance of a probability distribution is distinct from its mean. Rather, the purpose is to ask whether markets are adequately pricing these macroeconomic concerns into their assessment of market and credit risk when entering into investment transactions. If not, the search for higher yields, documented in several chapters of this Annual Report, could easily turn into a widespread search for enhanced protection should bad news emerge from whatever source.

Swings of sentiment in financial markets are by no means new, but there may be particular problems of interpretation should asset price increases take place against a backdrop of otherwise low inflation and changing financial structure. This issue, and others pertaining to the pursuit of price stability in the current climate, are discussed below. Such swings of sentiment may also have implications for the health of the financial system and the economy more broadly. Since there is no agreed method of identifying "irrational exuberance" ex ante, it is thus all the more important to design a framework which will preserve the stability of the financial system, regardless of the kinds of shocks or the degree of asset price inflation to which it might be subjected. This issue, which is of interest to central bankers as well as other supervisors, is also discussed further below.

Pursuing and maintaining price stability

Recent improvements in inflation performance in most industrial, many emerging and some transition economies are clearly to be welcomed. The costs of inflation are now well recognised, particularly by those policy-makers in industrial countries who have spent the best part of 20 years trying to bring inflation back under control. Yet, in moving to a lower rate of inflation, certain dangers arise and some existing uncertainties pertaining to the conduct of monetary policy can be exacerbated. The objectives, transmission channels and instruments of monetary policy may all have to be seen in a somewhat different light.

In industrial countries and also in most emerging economies, it is now conventional wisdom that the principal objective of monetary policy should be domestic price stability. This not only avoids longer-term inflationary bias but also leads to automatic countercyclical movements of monetary conditions. Inflationary finance, far from expanding output growth and employment, except in the very short run, may actually lead to the opposite outcome (see Graph VIII.2 in Chapter VIII). The only problem with a continuing state of low inflation is that it may cause people, even those in positions of authority, eventually to forget this message and to seek again to push demand beyond sustainable limits. This potential for "memory failure", with costs that may span decades, argues strongly in favour of central banks being given a clear mandate to ensure price stability, along with the capacity to exercise their powers autonomously within a framework of public accountability.

A similar temptation to shift objectives can arise if the real exchange rate appreciates sharply in the context of a disinflationary monetary policy and the trade balance deteriorates. A relatively benign sequel, as observed over the last decade in Canada, is that the nominal exchange rate subsequently declines in a gradual way as the economy slows; competitiveness is thus restored, even if some of the disinflationary benefits of the earlier exchange rate strength have to be surrendered. This may also be the pattern that will be followed in the case of the US dollar should the external balance fail to improve. With output in the United States essentially at full capacity, however, stronger demand from abroad will have to be accompanied by measures to slow domestic demand if an inflationary outcome is to be avoided.

A more troubling outcome following real exchange rate appreciation, often seen in the past in Latin America, is that policy is suddenly shifted radically in the direction of encouraging external balance through currency depreciation. Such a shift is all the more likely if a weak domestic financial system increases the pressure for growth-oriented policies. Still more harmful, the market itself may come to believe that the external deficit is no longer sustainable and a currency crisis may be precipitated in consequence. In such cases, domestic prices may rise particularly sharply as the exchange rate falls.

While this apparent policy conflict between internal and external balance can be serious, and is often exacerbated by capital inflows, it certainly does not warrant abandoning the objective of price stability. To do so would only expose the country to recurrent bouts of inflation and depreciation which would ultimately make inflation expectations extremely unstable in an upward direction. Indeed, this is the fundamental problem, arising from the inflationary history itself, which makes it so difficult to reduce inflation in many Latin American countries and which accounts for significant real exchange rate appreciation whenever monetary policies are directed to this end. For Asian countries, the historical record of more stable prices has, at least until recently, protected them from such a dangerous process. The policy conclusion would seem to be that a good inflation record should be defended with the utmost vigour, using monetary and fiscal policies in as balanced a way as possible. In contrast, those with a bad inflation record will have to give prominence to fiscal and other policies to restore credibility, which in turn will limit the adverse side-effects that firm monetary policies tend to have on the external balance.

Even with the objective of price stability firmly established, further uncertainties connected with the operation of the transmission mechanism can complicate the conduct of monetary policy. The first of these complications is the need to define more precisely what is meant by price stability. While opinion in the industrial countries seems to have converged around a target range for inflation of between zero and about 2%, arguments can be advanced for both less and more ambitious targets. In many emerging market economies, and a few industrial ones, the more pertinent question is how rapidly to bring down inflation rates that are still considered to be too high.

The answer to both questions depends on two related considerations: how quickly domestic wages and prices respond to disciplined demand policies, and how quickly inflation expectations can be made to adjust. Labour and product market reforms directed to increasing price flexibility can contribute to the former goal, and thereby limit the short-term output losses associated with reducing inflation. At the same time, such reforms can also lower structural unemployment, which is a permanent cost to any economy and a particular burden in Europe today. Supportive fiscal policies also have dual benefits, strengthening the credibility of monetary policy in the short term, while addressing as well the need for fiscal stabilisation in the medium term. Moreover, combining these sets of reforms could well produce benefits considerably greater than the sum of the parts, helping in particular to resolve the problem of internal and external balance referred to above.

In the last few years, uncertainty as to how to respond to movements in the prices of certain financial assets has also been a problem. Rapid increases in the prices of equities have occurred contemporaneously with the maintenance of relatively low inflation in many industrial countries. In a number of Asian countries, property prices, fuelled by credit creation, have also been rising rapidly. While such gains in wealth and reductions in the cost of capital might be thought likely to intensify demand pressures, the timing and the magnitude of these effects remain uncertain. Leaning too heavily against these influences, particularly if inflation is already low, risks more generalised deflation. On the other hand, failure to lean sufficiently runs the risk of a sudden collapse, also with potential systemic implications, as witnessed in Japan in the early 1990s. Perhaps the answer is to be found less in a discretionary monetary policy response and more in prudential norms designed to limit further lending against assets whose price has become highly inflated. Indeed, recent history seems to indicate that the most serious problems affecting asset markets and banking systems, in both industrial and emerging market economies, have arisen in the wake of financial market deregulation which has been either too rapid or poorly conceived.

In some countries, the conduct of monetary policy in recent years has also had to deal with significant changes in the exchange rate. Even disregarding the external balance issue discussed above, a, for example, appreciating nominal exchange rate tends to lower domestic prices. Should policy rates respond to this or not? Ideally, the answer would be couched within the framework of an explicit inflation forecast which would identify why the exchange rate was rising. If the cause is some expansionary shock, such as a positive change in the terms of trade or an increase in exports, there should be more of an inclination to leave interest rates unchanged. Conversely, if the exchange rate appreciation is not so caused, interest rates might be lowered, or raised less than would otherwise be necessary. Since forecasts are made only at discrete intervals, some countries have chosen to systemise their response to exchange rate movements in the intervening period by setting an interim target for a monetary conditions index, that is, a weighted average of interest rates and exchange rates. This is a sensible approach given two assumptions: that exchange rate shocks do not normally reflect forces having an independent effect on inflationary conditions, and that the exchange rate change lasts long enough to have effects on the domestic economy. Needless to say, not all central banks would agree that these assumptions are correct in their particular case.

Nor are these the only factors complicating the conduct of macroeconomic policy in current circumstances. For example, in several industrial countries uncertainty prevails as to whether there has been a shift in the "natural" rate of unemployment. Furthermore, as stocks of assets and liabilities have expanded rapidly in recent years, the possibility of new forms of interaction in response to interest rate changes has also risen. In some English-speaking countries in particular, high levels of household debt of relatively short duration could imply an unusually sharp response to monetary tightening. In a number of emerging market economies, structural and environmental limits to growth are being revealed and deficiencies in the data needed to carry out an effective monetary policy are becoming increasingly evident.

Given all these uncertainties, two policy conclusions would seem justified. First, considering how easily things can go wrong, and the asymmetric consequences of policy errors, perhaps basic macroeconomic objectives should be set in a more demanding way. Viewed from this perspective, the objective of simply stabilising government debt/GDP ratios must be seen as inadequate, since at some time there will inevitably be another recession which will push them back up. Similarly, inflation reduction targets which lack ambition also lack conviction, and may fail to play the desired anchoring role in the face of inflationary shocks. Secondly, policy-makers should commit themselves more firmly and publicly to their basic objectives. Temporary deviations from desired paths are then less likely to be interpreted as a permanent abandonment of goals.

Over the last few years, many central banks have indeed become more transparent regarding both their objectives and their views about the transmission mechanism of monetary policy. Moreover, there has also been a more recent trend towards greater transparency in the implementation of monetary policy, as indicated by the increasing use of fixed rate tenders and explicit announcements of the authorities' desires with respect to short-term interest rates. Allied with a growing willingness to change interest rates in advance of a rise in measured inflation, some support may also be emerging for the view that warnings about prospective policy changes are likely to foster earlier and smoother reactions in longer-term markets. Such trends may eventually culminate in policy changes becoming so effectively pre-emptive as to be just as likely to be followed by a reversal of the policy move as by further moves in the same direction. This would imply that needed action had indeed been promptly taken, which would be a welcome development in the pursuit of both price stability and cyclical stabilisation.

Pursuing and maintaining financial stability

The liberalisation of financial markets, as of any other market linked to production and consumption, has an upside and a downside. Financial deregulation contributes to faster economic growth through a more efficient allocation of resources and a more cost-effective provision of financial services. Yet liberalised financial sectors are also more prone to costly misadventures, particularly if encouraged by a climate of macroeconomic instability. In a large number of industrial and emerging market economies, taxpayers have in recent years paid out a significant share of GDP to support and recapitalise failed banking systems. All too frequently, the subsequent macroeconomic effects in terms of lost output and rising unemployment have been considerably more costly. While we have not yet experienced the economic losses that might be associated with a major failure in payment systems, which now routinely process several trillion dollars' worth of payments a day, a few close calls in recent decades were wake-up calls as well.

Recent bouts of financial instability have had less to do with new financial instruments than with familiar shortcomings observed in liberalised banking markets. Violent asset price swings, generated by excessive credit expansion, often, but not always, accompanied by generalised inflationary pressures and capital inflows, have been a major source of recent turbulence. Weak governance of financial institutions, both internal and external, has also been a common problem, with excessive state interference and directed lending being important contributing factors. Deregulation without adequate training of managers and supervisors has also been commonly observed. All such problems have been particularly acute in the financial systems of emerging economies.

As if familiar shortcomings were not enough, prospective problems may arise from sharp increases in global competition in a world which is already overbanked and where rents from established franchises are being threatened by new technology. Electronic trading has reduced margins in foreign exchange, while an increasing number of firms now possess the sophistication to compete in the "plain vanilla" end of derivatives markets. The physical proximity to customers provided by branches is less and less required. Sophisticated over-the-counter instruments have put exchange-based trading on the defensive. Traditional intermediation faces intense competition from collateralised lending and securitisation. Finally, deregulation and the active encouragement of international competition between different types of financial institution will add to the pressure for adjustment. Indeed, we already seem to be well on the way towards a world with no barriers to universal banking and significantly greater competition from securities markets than hitherto. The introduction of the euro is likely to reinforce all of these trends in Europe.

In itself, a need for adjustment is no bad thing; it is the process of competition that produces the benefits noted above. However, the adjustment should be orderly. Firms must be allowed to respond to competitive pressures by increasing efficiency even if it involves reduced employment. Capital that earns an inadequate rate of return should be withdrawn and firms must be allowed to merge, even with foreign partners, or to disappear. The problem, and it applies to many emerging markets and perhaps even more to some industrial countries, is that these preconditions are currently not always fulfilled. The resulting danger is that the whole financial system may weaken and that firms under pressure will be increasingly inclined to take more risk to "gamble for resurrection". Whether or not this already partly explains the greater appetite for risk evident in today's financial markets, it would be consistent with patterns of behaviour seen in the banking systems of industrial countries during the last 20 years.

What, in addition to providing a more stable macroeconomic environment, still needs to be done to strengthen the financial system in these changing circumstances? The first answer is that individual financial institutions need to be better governed. This calls for a complementary mixture of more internal discipline, more market discipline and more supervisory discipline. Since each of these approaches has its drawbacks, there is an important role for all. The second answer is that the market infrastructure, particularly but not exclusively in emerging economies, needs to be strengthened to lessen the dangers of contagion across markets and across countries. The third answer is that a process needs to be initiated to make this happen. Simply recognising problems and appropriate solutions is not enough; action must follow.

Better internal governance of financial institutions is the first place to start. This requires that the money and jobs of owners and managers be self-evidently at stake. Capital adequacy standards contribute importantly to the former objective and should apply to all firms, both domestic and internationally active. Indeed, they are increasingly doing so as the Basle Capital Accord gains worldwide acceptance. Moreover, it should be recognised that the incentives to monitor yields on invested capital closely, and to withdraw capital if yields are not commensurate with perceived risk, mount each time a financial firm is allowed to fail. From the systemic perspective, not all failures are bad.

As for managers, it should be noted that most of the well-publicised trading losses of recent years had accumulated undetected over a very long period. Clearly, some internal risk management systems remain deficient in important respects, particularly when business is being conducted in geographically distant centres. The incentive systems for traders and other bankers also encourage inappropriate behaviour if gains (in profits or volumes) are rewarded but losses are borne by the firm as a whole. Finally, internal controls over exposure to individual sectors, such as property loans, need to be strengthened to limit the exuberance that normally emerges when a particular sector is doing especially well. And closely related to this, greater attention needs to be paid to exposures to new instruments and to settlement risk as transaction volumes continue to expand rapidly.

Market discipline relies on good information being provided to counterparties and others who would be affected should a financial institution encounter stress or fail. The most fundamental requirement is that all firms adhere to accounting principles that ensure that financial balances are fully and accurately reported in a transparent way. In many emerging markets this is not the case, and even in industrial countries differing accounting standards render comparisons difficult. Renewed efforts in the International Accounting Standards Committee (IASC) have the strong encouragement of the BIS and the Basle Committee on Banking Supervision, which has also established an accounting task force to liaise with the IASC in the banking area.

Yet the market discipline fostered by disclosure requires more than just good accounting. Experience with enhanced disclosure concerning activities in derivatives markets may have parallels in many other areas. The basic dynamic is for a few well-respected firms to be persuaded by the authorities to improve their disclosure practices, thus making firms which do not disclose look as if they have something to hide. A similar process of peer group pressure is expected to be put in place with the finalisation in September this year of the Core Principles for Effective Banking Supervision. Moreover, rating agencies are likely to play a major role in helping the market enforce standards established either by supervisory authorities or by self-regulatory bodies in the industry itself. Rating agencies have in fact substantially extended their interest in the financial institutions of emerging markets in recent years.

Despite the welcome support from market forces, it must be recognised that market discipline will never be sufficient on its own. First, the markets themselves are subject to excessive swings of sentiment, as recorded in several chapters of this Annual Report. Secondly, information will inevitably arrive late and be uneven in quality. Finally, in many countries safety-net provisions are either large or so indeterminate as to be thought large. Such provisions dull the incentives for markets to exert discipline even when they have the information needed to do so. Thus, there will always be a role for supervisors, even if the discipline they impose becomes over time less the direct product of traditional regulation and increasingly the indirect product of their support for better internal governance and market discipline.

Structural changes affecting both time and space pose many challenges for supervisory authorities. In the dimension of time, change is occurring very rapidly, making it increasingly difficult for supervisors to keep detailed regulations up to date, particularly when short of personnel. This desire to keep close to evolving market practices is one of the motivations behind the decision to allow the use of internal models for the calculation of capital requirements for market risk. At some time, the supervisors will also face the issue of whether similar models should be used for the evaluation of credit risk, and the still broader question of what dangers are inherent in reducing the measurement of all risks down to just one number. Still in the dimension of time, exposures can now be changed almost instantaneously and crises can erupt with equal speed. It is not clear that the information channels between all those public officials responsible for coping with such problems are yet up to the task.

Finally, and now in the dimension of space, as the roles played by financial institutions and financial instruments increasingly overlap, the maintenance of separate regulatory bodies for different categories of institution can create complications. In a number of countries, notably in Scandinavia, "umbrella" supervisory agencies have been formed, and lively debate on this issue is in progress in some other countries. In recognition of these trends, closer cooperation is being developed between the Basle Committee, IOSCO and the IAIS in the framework of the Joint Forum on Financial Conglomerates. However, differences in national supervisory arrangements and in the banking, securities and insurance culture make rapid progress difficult.

The second major requirement for strengthening the financial system is, as mentioned above, to improve the infrastructure supporting the international financial system. Payment and settlement systems worldwide need to be made risk-proof to ensure timely completion of all transactions. As in the supervisory area, more emphasis needs to be, and is being, put on disclosure and the exercise of market discipline. Participants in securities markets now have access to a questionnaire to help them determine the safety of local settlement arrangements. Moreover, participants in the foreign exchange markets have been urged to find ways to reduce the risks involved in settling foreign exchange transactions.

The last requirement is a more general one of process. Having determined what needs to be done, how do policy-makers ensure that it happens? The report recently released by the Working Party of the Group of Ten Deputies on Financial Stability in Emerging Market Economies is particularly instructive in this regard. The report concludes that international norms and understandings about principles of sound practice should be developed through an international consultative process involving national experts with extensive experience and knowledge of the matter at hand. In this context, the efforts of the Basle Committee on Banking Supervision and the Committee on Payment and Settlement Systems constitute textbook examples of how such a mechanism can work and how experts from emerging markets can be increasingly drawn into the process. National authorities must then bear the responsibility for adopting and implementing the norms. International institutions such as the IMF and the World Bank should support this process by monitoring developments and providing the advice, technical assistance and training necessary for the adoption and implementation of sound principles and practices. In addition, they, as well as others with relevant experience or insight, should suggest to those responsible for drawing up these norms ways in which they might be further improved. The challenge for the next few years will be to move this process forward in practice, and in so doing help make the global financial system both more efficient and more safe.