Mr George takes a look at the potential volatility of private credit and investment flows

Speech given by The Rt Hon Eddie George, Governor of the Bank of England, to the Bankers Club Annual Banquet at the Guildhall, London on 14 February 2000.

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In my remarks last year I ventured to suggest that the darkest storm clouds might have lifted just a little following the global financial upheavals of 1997 and 1998. It was a bold prediction for a central banker.

But over the intervening period the skies have continued to clear as the clouds of financial instability dispersed. But clouds can return and the outlook for the medium term is for sunny periods with occasional showers. For the time being, though, we enter into the new millennium with the world economy as a whole basking in the glow of at least relatively warm sunshine.

The rate of world output growth which had fallen to only about 2% in 1998, about half its long-term trend rate, and which was widely expected to fall further, is now expected to bounce back to around trend over the next couple of years. And whereas, a year ago, many industrial countries were still in the process of easing monetary policy, to offset the impact on world demand of the interruption of the flow of credit and investment to emerging market countries and transition economies, we have recently seen a quite widespread increase in interest rates, designed to moderate the pace of domestic demand growth. I don't need to convince *this* audience that rising interest rates are a reflection of a strengthening economy. And more even than that, we have all come through our technical examination on Y2K transition with flying colours - I congratulate you all on that achievement.

But central bankers are not paid, Mr President, to look on the bright side of things. We are paid to worry, to worry about what might go wrong and to anticipate the clouds coming over the horizon. We don't have to be particularly inventive to find plenty of work to do! I should like to share some of those worries with you this evening relating in particular to the potential volatility of private credit and investment flows.

Few people now question the positive role of free private financial markets - nationally and internationally - as a powerful driver of economic growth. Markets may not be perfect but they are in general the best means we have of allocating financial resources to where they can be most productively used. The debate is rather about the conditions that are necessary for financial markets to function more efficiently. That would help to reduce the risks of, and limit the damage from, sudden swings in market sentiment with their potentially disruptive effect on economic and financial stability.

It is certainly not a new debate. But it becomes increasingly pressing with the growing scale of financial intermediation and globalisation. And it is of obvious importance not just for those of us in the public sector concerned with the macro-economic effects, but equally for you who are engaged in financial intermediation in the private sector concerned with managing the risks in your individual businesses.

The most immediate challenges relate to the build-up of imbalances within and between the major industrial countries. Moving into the global economic recovery, the US - and the UK - are already operating close to overall capacity with ultimately unsustainable growth of domestic demand offset by already sizeable external current account deficits. The Eurozone as a whole may have more spare capacity - even allowing for structural, supply-side, constraints - and is now seeing a recovery in domestic demand growth. Meanwhile Japan is still aiming to promote a self-sustaining pick-up in domestic demand after a prolonged period of weakness, reflected in a large current account surplus.

Looking ahead - and we have to look ahead because macro-economic policies take time to have their full effects - I suppose that, if we could ordain these things, we might choose - in a virtual world economy - to seek to underpin a more obviously sustainable growth pattern - through a combination of fiscal and monetary policies designed to affect the relative pace of domestic demand growth in the different countries (somewhat slower in the US and UK and somewhat stronger in the Eurozone and, particularly, in Japan), and to support relative exchange rates that would contribute to better balanced external positions. No doubt we could program a computer to tell us precisely how to do it!

It is not quite so easy in the real world! In the real world the position is complicated among other things by capital flows. Capital is clearly flowing *out* of the Eurozone. This helps to explain the otherwise puzzling weakness of the new single currency, which in turn is adding to net external demand, and modestly so far, to domestic inflation. Capital is flowing *into* the US - on a net basis - apparently attracted by productivity and prospective future earnings growth, and contributing to rising financial asset prices, and associated wealth effects on US domestic demand. Capital is also obviously flowing *into* this country - for reasons that I'm bound to admit are less apparent so far in the macro-economic data. Capital also flowed back into Japan in the latter part of last year, giving rise to sudden strong upward pressure on the Yen and putting at risk economic recovery.

What is not clear is how far these capital flows are a reflection of underlying economic factors and how far they are likely to be sustained. It is possible - and I mean it really is possible - that they will abate gradually, allowing a better balance between domestic and external demand to emerge. It is also possible that the financial markets will overshoot and that we will then see a more abrupt adjustment.

There are limits to what policy can do directly to address these concerns. On the monetary side, we can - and do - take account of the effects of changes in asset prices, and of exchange rate movements, on overall demand and price pressures as best we can, both in our forecasts and in our interest rate judgements. We can hope in this way to maintain reasonable stability - reflected in consistently low inflation - in our economies as a whole; but we cannot easily avoid sectoral imbalances arising from exaggerated capital flows or the disruptive effects if they are subsequently reversed. We can draw the attention of financial market intermediaries to possible risks as we see them. And we can, through our regulatory and supervisory processes try to ensure that individual institutions do not become over-exposed to particular market risks. But it would be a serious mistake if we were to try to go further and try to impose our views on the markets. We would almost certainly fail - given the weight of private capital flows and diversity of channels through which they can move. And your collective judgements are likely to be at least as good as ours, given that it is you who stand to lose directly if your judgements turn out to be wrong.

Mr President, even relatively small adjustments among the industrial countries could have wider repercussions in the rest of the world. And although the capital flow to emerging market countries and transition economies is now recovering, it is clearly important that we keep up the momentum of the extensive efforts made over the past two years both to reduce the risk of, and to improve our capacity to manage, excessive volatility of capital flows in the wider international context.

In fact, although it often seems that the international debate moves forward at a snail's pace, we are making considerable progress towards reducing the risks.

In particular a great deal of work has been done to produce codes of good practice

- on data dissemination,
- on transparency of monetary and fiscal policies,
- on the framework of financial and supervisory policies,

all within the IMF;

- on international and domestic debt and liquidity management, in the Financial Stability Forum Working Group on Capital Flows,
- on core principles for effective banking supervision, in the Basel Committee,
- on core principles for systemically important payment systems, in the Basel Committee on Payments and Settlement Systems,

- on accountancy standards, in the International Accounting Standards Committee,
- on auditing and audit practice, in the International Federation of Accountants,
- on cross-border insolvency law, in the UN Commission on International Trade Law,
- and on corporate governance, in the OECD.

The emphasis now has to be on *implementation* by national authorities, with the help where necessary of the international community. And although that cannot happen overnight, the emphasis must be, also, on transparency and validation of *progress towards* implementation in individual countries. These questions are being addressed by the IMF, and in both the Financial Stability Forum and in the G20.

Taken together all these initiatives should contribute to greater stability at the national level. But they should also help lenders and investors better to assess the risks of lending to or investing in one country as against another, dampening potential volatility and, at the same time, giving the countries stronger incentives to move towards best practice.

We are making good progress, too, in strengthening financial regulation in *industrial countries*.

- The Basel Committee has put forward proposals for revising the capital accord, and has issued a series of papers relating to credit risk management.
- IOSCO has made recommendations on dealings with highly leveraged institutions (HLIs),
- and an FSF Working Group is looking more broadly at ways of reducing the destabilising potential of HLIs.
- Another FSF Working Group is looking at the implications for financial stability of offshore financial centres.

The list could easily be extended - and no doubt will be. But all these initiatives represent significant progress in terms of crisis prevention.

Where there has been less progress so far - despite a great deal of debate - is on crisis management. We have not yet advanced much beyond the principles and tools set out in the G7 communiqué from the Cologne summit in June.

Broadly, having emphasised the importance of not undermining contractual obligations, the principles stress that *all* private creditors should accept responsibility for their lending and investment decisions - without expecting to be underwritten by the official sector, and they encourage cooperative solutions between the debtor country and its creditors, building on effective dialogues established in advance.

The tools link official support to efforts by the debtor country to obtain private financing - or maintain existing exposures - on a voluntary basis, and provide for comparability of treatment within the Paris Club, of all categories of creditors other than international financial institutions. They include mechanisms that can be used to limit the use of official financing to fund external deficits or domestic capital outflows or to repay private sector debt. And they provide ultimately for capital controls, as part of payments standstills, in conjunction with IMF programmes.

So we have the principles and we have the tools. The problem is that we don't at this stage have a very clear idea as to how they might be applied in any particular case. I agree that each case is different and you can't have hard and fast rules. But we do need to develop *some* kind of presumption of what debtor countries and their creditors might expect, before the next crisis hits us because that will influence their behaviour in the meantime.

Of course it is very tempting to avoid what is a very difficult issue. In the case of a relatively mild external liquidity shock the presumption is that a country maintaining prudent policies and which has the correct defences in place could look to the IMF for support under the new contingent credit line facility. This is designed to signal the Fund's confidence in the country's policies and see it through to the point where it can regain access to financial markets.

But that's the relatively easy bit. The issues are more difficult when the circumstances are less benign. What we all have to recognise is that the exceptional amounts of official funding committed during the Asian crisis are far less likely to be forthcoming in future. And to the extent that official funding *is* forthcoming, conditions may well be attached to ensure that it is not used simply to re-finance repayments of short-term debt to private sector creditors or to fund a resident capital outflow. Several of the tools which the G7 communiqué identified are designed to have precisely this effect.

The last thing that the official community wants is to get dragged into the micro-management of relations between debtor countries and their creditors. But if that is not to happen, it seems to me that borrowing countries and their major creditors - above all the short-term lenders - would be well advised to establish, during the good times but on an ongoing basis, arrangements for regular dialogue.

But beyond that, we do need a broader dialogue on the pros and cons of an orderly suspension of external debt payments in more extreme situations. In principle it seems to me that this could have advantages for committed private sector creditors, as well as for the official community to prevent free riders running for the exit, or seeking to attach assets, and provide time for orderly negotiations on the provision of new finance, or for equitable debt rescheduling. It should enhance the prospective value of private creditors' claims by, in effect, "bailing in" both official financing and internationally-endorsed policy actions to correct the underlying problems. That must be better than sometimes hastily-considered unilateral action. The chances otherwise are that the more responsible private creditors would find themselves in the position of official lenders, with their funds used simply to finance a capital outflow.

Mr President, the debate - particularly on crisis management - still has a long way to run. But if we on the official side do not engage with you in the private sector in that debate - facing up *together* to how best to handle the really hard cases - during the present period of relative calm in global financial markets, then my fear is that when next the storm breaks - as it undoubtedly will at some point - we will again find that we are making things up as we go along. I would hope that we might do better than that.

My purpose in worrying aloud tonight has not been to keep you awake at night. My purpose has been to draw your attention to some of the risks that we will undoubtedly have to contend with together in the future, and to suggest that we have a mutual interest in working together now to minimise those risks.