

## Jaime Caruana: The impact of geopolitical events on the world economy

Speech by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of The Basel Committee on Banking Supervision, at the International Securities Market Association Annual General Meeting, Madrid, 27 June 2003.

\* \* \*

It is a great pleasure for me to participate today in this International Securities Market Association Annual General Meeting. I would like to thank the organisers for their kind invitation to open this meeting and also to welcome you all to Madrid. The matters to be addressed in the Conference are not only highly topical, but are of crucial importance for all of us. Given the prestige of those who will be offering their opinions, I believe it will be a great opportunity to draw conclusions of enormous interest.

The broad theme for this conference is the impact of geopolitical events on the world economy. By way of introduction, let me briefly share with you some thoughts on this topic.

The world economy has been through a complicated period in recent years. The expected recovery has been slow, hesitant and disappointing. Several factors have come into play in this connection. On one hand, the persistent impact of the bursting of the IT and stock exchange bubbles has had a negative effect on business and consumer confidence as well as on investment. On the other hand, several shocks have further undermined confidence, among which I would highlight September 11, geopolitical tensions - in particular the conflicts in Afghanistan and Iraq - and corporate scandals. All this has created an environment of uncertainty over world economic prospects and has led to heightened risk aversion. Finally, crises have continued to beset certain emerging market economies, such as Argentina and Turkey.

Both the real sector and certain segments of the financial sector have been affected by this series of shocks. Equity markets have suffered a protracted depression worldwide. The fall in stock prices has fed back into aggregate demand, although in many countries this negative wealth effect has been offset, at least partially, by a buoyant home market.

As usual, one can see the bottle as being half-empty or half-full: admittedly, the recovery is proving mild, but it is also true that this is partly a result of the mildness of the previous recession and that a deep recession has been avoided. Conditions for higher global growth in the second half of this year seem to be in place and prospects for 2003 point to world GDP growth of between 3% and 3.5%, slightly above that for 2002, and an additional improvement is expected in 2004 (around 4%).

However, it is also true that this recovery is proving atypical in several respects, among which I would stress five:

**First**, in geographical terms, the recovery has been rather uneven so far. On one hand, the United States, central and eastern Europe and - until the recent SARS epidemic - East Asia have been showing greater vigour. On the other hand, there has been economic stagnation in Japan, very modest growth in the euro-zone and a very disappointing performance in Latin America.

**Second**, in contrast with the usual pattern in recovery phases, certain variables are showing no signs of improvement. Let me mention two: first, investment, despite the low level of interest rates, perhaps because of overcapacity in certain sectors, but mainly because of an overall lack of confidence in the recovery; and second, employment, which, particularly in the case of the US, continues showing signs of weakness.

**Third**, macroeconomic policies have generally been more expansionary. Interest rates are at historically low levels, both in nominal and real terms, in most countries, and this applies also to the longer segments of the yield curve. Overall, fiscal policies are clearly expansionary, although the room for manoeuvre available to different countries in this regard varies greatly.

**Fourth**, the current-account imbalances among the largest economies were exacerbated during the recession and the early stages of the recovery and their geographical distribution does not bode well for their correction. One particular reason for concern is that the huge US current-account deficit coincides with the role of the US as the only locomotive of the world economy in recent years.

As mentioned before, forecasts generally point to a firming of the recovery in the second half of 2003 and an additional improvement in 2004. Despite the rapid conclusion of the war in Iraq and the improvement in financial markets sentiment in recent weeks, the economic data and indicators do not yet show an unambiguous improvement, partly because some of them are still contaminated by geopolitical uncertainties, and partly because other imbalances and factors of uncertainty still persist.

The **fifth** element I would like to stress today is the resilience of the global banking system in most developed countries. This capacity of the banking system to withstand diverse shocks was pivotal in maintaining a certain degree of dynamism in the world economy.

One of the lessons of the past few years is the importance of financial markets in the functioning of the world economy, and the complexity of the channels of interaction between such markets and the real economy.

This simple idea has fostered quite a number of initiatives, at the national and international level, to reinforce the resilience and efficiency of financial markets. Topics that used to be too technical and tedious, such as accounting and corporate governance, have become exciting and the centrepiece of many reform agendas.

Let me mention just three issues in this regard:

### **First: Financial market integration**

I believe that one factor which can and should prove fundamental to strengthening the world economy is the integration of international financial markets.

The integration of financial markets will promote both competition and transparency and will enhance liquidity. Investors will benefit not only from a reduction in transaction costs, but also from an increase in investment opportunities, allowing them to manage risk better. Companies, for their part, will find it easier to raise funds to develop their activities.

To be sure, in recent years, we have seen impressive advances in the degree of integration of international capital markets. This has fostered a better allocation of saving and improvements in efficiency from which we have all benefited. At the same time, this process has also entailed a more rapid transmission of shocks, whether or not these are generated in financial markets.

In the European Union, although the process has been given notable momentum thanks to the introduction of the euro and to a series of measures such as the Financial Services Action Plan (FSAP), we are still a long way from achieving fully integrated markets, so that an additional impulse is required.

### **Second: Accounting harmonisation**

Among all the developments needed to bring about market integration, let me mention one that seems to me particularly important: accounting harmonization or convergence at the international level.

Financial information is of crucial importance for the proper functioning of the financial system, since it is the basis on which agents make their decisions. Retaining their confidence in the reliability, relevance and timeliness of such information is vital.

Currently, the cross-country comparison of financial information is difficult, since the set of rules under which such information is compiled varies from country to country. Moreover, the interpretation of such rules is not always uniform. This is cost-inefficient for those companies having to comply with different accounting regulations because they operate in more than one geographical region. Likewise, the lack of comparability may hamper cross-border activity and decision-making by investors.

There have been some encouraging developments in this area. First, is the memorandum of understanding between the IASB and the Financial Accounting Standards Board (FASB) formalising a commitment to convergence towards common principle based accounting standards. Admittedly, this will not be an easy task, but it seems vital to move in this direction.

Second, the European Union has taken a significant step forward. It has resolutely considered need to promote the comparability of different countries' financial information as an unavoidable prerequisite for achieving the single financial market.

Accordingly, a Regulation was approved last year adopting the International Accounting Standards (IAS). Specifically, in 2005 companies listed on regulated financial markets will have to prepare their consolidated financial statements in accordance with these standards. The thrust of this Regulation is to achieve clear pan-European rules for comparable, transparent financial reporting throughout the European Union. Rules which will make companies provide relevant and reliable information for investors and other stakeholders so that they can make meaningful cross-border and cross-sector comparisons.

But accounting regulation also poses significant difficulties. In banking, one of the most important challenges for accounting standard setters is to achieve consistency with sound risk-management practices. Incentives built in to the accounting rules should be compatible with and encourage good risk management. In this connection, the areas of financial instrument accounting and transparency rules require special attention.

This idea of market friendly incentive-oriented rules leads me to my last remark on the role of prudential regulation.

### **Third: Efficient risk management**

One key question that we prudential regulators should ask ourselves is whether regulations provide the right incentives to assess and to manage risks properly. This question is directed at the very essence of financial regulation, whose basic aim is to ensure the stability of the financial system without being too intrusive or undermining its efficiency. Providing market friendly incentives for efficient risk management is probably the best contribution we can make to foster financial resilience.

As you know this is one of the key objectives of the new Basel Capital Accord, the so-called Basel II. Let me just mention that in designing the new standards we have been and will continue to be sensitive to the possible implications for financial markets in terms of liquidity and potential development. This is especially so in areas such as securitisation and collateralised transactions.

The implementation of Basel II will contribute to enhanced risk management by banking institutions. This initiative, along with others related to a general improvement of standards and practices in several areas, would contribute to the better functioning of financial institutions and markets, leading ultimately to a full harnessing of the benefits of financial integration.

I trust that, with fluent dialogue between regulators, institutions and market participants, we may be able to improve the combination of sound regulation and flexibility that would ultimately lead to a more robust and efficient financial system. I am convinced that this is a most important contribution to the smooth functioning of the world economy.

Thank you.