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REMARKS ON THE EVOLUTION OF THE INTERNATIONAL FINANCIAL SYSTEM

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Having participated over the last thirty years or so in the annual meetings of the International Monetary Fund and the World Bank, I thought it might be interesting, from a historical perspective, to roughly sketch the main themes of those meetings as they have evolved over the last decades.

As I recall, in the sixties and seventies, one used to stress :

- the dangers of inflation,
- together with the need to reduce fiscal deficits.

Then, in the eighties, as one had paid little attention to the recommendations on budgetary discipline, the emphasis shifted to the dangers of excessive public debt (domestic and external).

Today, the two dominant themes are :

- the excesses of private sector indebtedness,
- and the need to rehabilitate and strengthen the banking systems notably in emerging countries.

Thus, there has been a shift from the combined concern : "Public budgets/Inflation" to a more systemic preoccupation : "How to avoid the excesses of indebtedness of the private sector and to improve on the functioning of financial institutions ?"

In a way, the themes of these annual meetings have become both privatized and globalized. This is because the world has, in fact, profoundly changed over that period.

I shall try to briefly outline some of the main traits of this evolution.

I- THE WAY THE INTERNATIONAL FINANCIAL SYSTEM IS FUNCTIONING IS STRONGLY INFLUENCED BY THE POSITIVE RESULTS OF ANTI-INFLATIONARY POLICIES OVER THE LAST TWO DECADES, AND BY AN UNPRECEDENTED MOVEMENT TOWARDS LIBERALIZATION, BUT ALSO BY THE LINGERING CONSEQUENCES OF THE MACROECONOMIC MISTAKES OF THE SIXTIES AND SEVENTIES :

1. Anti-inflationary policies have made a great impact.

   These policies have had fundamental consequences on the financial system and on behavior. They have put an end to "monetary illusion" and to the perversions of negative real interest rates which were so common in the seventies, and which exerted such a toll on the allocation of resources.

2. The second factor of transformation has been financial deregulation, liberalization of capital movements and the elimination of exchange controls.

   One has moved from a compartmentalized world where capital movements basically "accompanied" physical flows of goods and services, to an open world where capital movements dominate the financial markets by their size and their speed.

   The revolution in information technology and in communications has enormously amplified these changes.

3. But the macroeconomic imbalances of the sixties and seventies continue, through the size of public indebtedness, to influence the reality of today.

   Budgetary deficits of the past decades have accumulated in major public debt positions.

   In a world where inflation measured by prices of goods and services is more and more contained, where capital movements are free, and where savers can choose the currency of their investment, governments no longer have the freedom to settle their debts in a depreciated currency. States must pay positive real interest rates if they want to borrow. This new and hard reality has led governments to reduce their fiscal deficits by containing the increases in public expenses, by intensifying fiscal pressure and by engaging in an unprecedented move towards privatization. The objective being, through the reduction of public deficits, to contain, and hopefully to reduce, the burden of the public debt on the economy.

Although this structural rehabilitation of public budgets is far from being completed –particularly in Latin America-, it is starting to show some results. A number of industrialized countries (with the exception of Japan) and of emerging countries have now reached a balanced position, and even a surplus in their primary budgets (without debt service payments). Thus, the primary budget position of European Union countries has gone from – 2,2 % of GDP in 1982, to + 2,1 % in 1999, a swing of more than 4 percentage points. For the United States, the swing has been more than 5 points (from – 1,7 % to + 3,4 %) over the same period.

As a result, in countries where fiscal rehabilitation is not yet completed, budget policy is, for structural reasons, more constrained today than it was in the past, and is not as easily usable as a macroeconomic adjustment instrument. This puts more responsibilities on monetary policy.

II- THIS NEW SETTING –REDUCED INFLATION OF CURRENT GOODS AND SERVICES, FREEDOM OF CAPITAL MOVEMENTS AND REHABILITATION OF PUBLIC BUDGETS- ENTAILS OR IS ACCOMPANIED BY A PROFOUND CHANGE IN THE FUNCTIONING OF THE INTERNATIONAL FINANCIAL SYSTEM :

1. Private capital flows are the main source of the world's financing.

In the seventies, net capital flows directed to emerging economies amounted to some 100 billion dollars per year, half of which was coming from official sources.

In 1996 (before the South East Asian crisis), the figures in real terms had tripled. The order of magnitude was 300 billion dollars. But, and this is perhaps more meaningful, almost all of those financial flows were coming from private sources (markets, credits, foreign direct investment). Since then, commercial banks have sharply reduced their net annual flows by some 100 billion dollars, and the official flows are now around 40 billion dollars. Over the last two years, the total amount is thus of the order of 200 billion dollars per year, half of which comes from foreign direct investment which has been the most stable element of all.

2. At the same time, it is the private sector which has became the central player on the macroeconomic scene. It is also the focal point of financial crises.

Whilst the share of public budgets in the GDP's of a number of countries is declining, it is notable that the growing current account imbalances are essentially caused by the private sector. The "twin deficits" of the past have been replaced by private deficits. This was particularly clear in South East Asia. For example, the budgets of Indonesia, South Korea and Thailand registered substantial surpluses in the years 1995-96. But those surpluses came with significant current account deficits. It is the financing of those deficits, through an explosion of shorter and shorter debt, which has triggered the bubbles in asset prices and, eventually, the exchange crisis of 1997.

In other words, because of the excessive growth of credit over the past few years, one has observed a shift from the couple : "fiscal deficits/inflation of current goods and services" to the couple : "insufficient private savings/asset price inflation".

This is a fundamental change in the macroeconomic setting. This change puts more burden on monetary policy and, in particular, on the control of the growth of credit.

III- THIS SITUATION HAS SEVERAL CONSEQUENCES FOR THE FUNCTIONING AND THE SURVEILLANCE OF THE INTERNATIONAL MONETARY SYSTEM :

1. The banking systems must be rehabilitated, strengthened and better equipped to handle the new risks.

In the nineties, the acceleration of the private debt in emerging countries has, in many cases, led to speculative investments accompanied by unsustainable share and real estate prices.

It is not financial liberalization that is the problem, but the combination of liberalization and of sick banking and financial systems incapable of dealing with risks in a professional, sound and non-political manner. That is what lies at the heart of emerging market crises.

An enormous and costly task is thus to be taken up by national and multilateral monetary authorities, by regulators, by those in charge of banking surveillance, by rating agencies and, above all, by financial

institutions themselves. Alongside the continuation of "fiscal mending", now is the time for rehabilitating, overseeing and recapitalizing financial institutions, in many countries. This will continue to exert a heavy toll on future growth. The experience of the last years shows that cleaning up overextend banks can be extremely costly : typically the burden can be of the order of 10 % of a given country's G.D.P..

2. Monetary policy is more and more complex.

Monetary policy must not only take into account the trends in monetary and credit aggregates, the movements in prices of current goods and services, but also asset prices and consequently their "wealth effects".

In a financial environment under constant change, where market instruments prevail over bank intermediation, where non-banks proliferate, where corporate defaults are dramatically increasing, and where financial innovation is creating everyday new forms of credits, credit surveillance is a major challenge. As J. Laurence Laughlin wrote in "Credit of the Nations", some eighty years ago : "inflation of money is the symptom, inflation of credit is the disease".

In a world where consumer psychology is in some countries, and in particular in the United States, so deeply dependent on the stock exchange, and where the value of collateral -which is by definition volatile- has a direct impact on the volume of credit and on consumption, one understands that the task of monetary authorities is particularly difficult. It is all the more so in that inflation is getting very awkward to define. If limited to current goods and services, the definition loses much of its meaning in a world dominated by strong financial markets and where future prices (which can be defined as current cash prices for future consumption of services and are reflected in asset prices) are particularly relevant. But if extended to financial assets, the definition of inflation raises delicate problems in terms of concept, measurement, and interpretation.

How to assess the medium-term profitability of a company and its relationship to the value of its shares ? Is profitability reduced in accounting terms because information technology investment costs are immediately included in current expenses as they arise? Is it, on the contrary, artificially increased by provisioning once for all the cost of restructuring and by the accounting methods adopted for the pooling of interests and for stock options ? In a world where certain investors and analysts are counting on -I should say "demanding"-, each year, a return

on equity of 15 to 20 %, share buybacks by companies can be a tempting way of increasing share values. But this can lead to excessive indebtedness.

Those issues were not, a few years ago, usual concerns for monetary authorities.

<u>3. Finally, exchange rate management is more and more uncertain.</u>

The exchange rate is a result of the balance of capital flows and the reflection of market opinion as to the sustainability of current account financing.

It is, in a way, the “circuit-breaker” of the system. In a world where most balances of payments and currencies are still national, where prices of current goods and services are relatively rigid and where capital movements are powerful, free and volatile, the flexibility of that “circuit-breaker” appears indispensable.

However, this flexibility gives rise to consequences which can be very detrimental to the economic and financial stability of individual countries. Large monetary entities are relatively better protected against these repercussions, especially when they are strongly integrated trade wise. It is the case of the United States and of the European Monetary Union.

But the problem is more acutely posed to medium size and small countries open on the rest of the world. Be they wise or not, they can be affected by market euphoria that can bring them at times significant inflows of capital. But they can, later on, -even if they are wise- be devastated by capital outflows, which can happen violently at any time following a political crisis, some bad news or a phenomenon of “regional contagion”. We have seen the outburst of such events last year.

In some respects, small virtuous countries are the most affected. What are their options ? Imposing exchange controls ? I don’t think so, although better control on short-term indebtedness of banks and enterprises seems to me indispensable. But from the standpoint of the exchange rate regime, what should they be doing ? Should they be pegging their currency to an external anchor ? Should they be adopting a Currency Board ? Should they be adopting adjustable pegs ? Should they be floating freely ? Or should they be joining with their neighbors and forming monetary unions linked to an adequate (tradewise) external anchor ? It is probably in this latter direction that, in the years to come, we will see the international

monetary system evolve. We already observe, for example in Central and Eastern Europe, a number of countries converging towards the Euro.

To conclude, let me say that the international financial system will remain fragile and volatile as long as a number of economies are characterized by excessive credit, weak private savings, and therefore by major imbalances in their current accounts. The prospects and modalities of the financing of these imbalances are uncertain and depend on market sentiment and the perception of the risks involved.

In other words, the classical notion of “adjustment” -which remains the leitmotive of thirty years of IMF annual meetings- will continue to be high on the agenda, even if the environment and the sources of imbalances have, as I have tried to show, profoundly changed over the years.

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