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The International Monetary System

Speech by the Governor of the Bank of Italy
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Contents

The present configuration of the international monetary system is the outcome of the spontaneous development of the interactions between different financial systems, in a regime marked by freedom of capital movements.

Banking systems' international activity has increased considerably; an even larger expansion has taken place in that of institutional investors, who receive savings and invest on a global scale.

New intermediaries and new markets have come into being, new instruments have been developed.

Repeated crises have slowed the growth of the international monetary system, but the volume of transactions and intermediated funds has nonetheless grown faster than world output.

It continues to be difficult to reduce the working of the international monetary system to a set of orderly and statistically well-defined flows of funds. It is even more difficult to capture the behaviour of intermediaries, markets and final users of funds in a model.

The endogenous forces at work within the system result, from time to time, in exchange rates and interest rates that can become cogent enough to influence the fundamentals and affect the underlying performance even of large economies.

The international monetary system is not governed. It does not have an anchor. It is powerfully influenced by the behaviour of the leading countries and currencies.

1. The international monetary system

Underlying every monetary regime is the search for an equilibrium between two often conflicting requirements: on the one hand, the credibility of the management of the currency, which is vital for maintaining confidence in the value of the monetary yardstick; on the other, the flexibility needed to attenuate the impact on the economy of unexpected shocks, of major events that are independent of the action of the monetary authorities.

The gold standard sacrificed flexibility for credibility. It did not hold up under the pressure generated by the profound economic, social and political changes that began with the First World War and spread in the following decades.

The international monetary order established at Bretton Woods was the last conscious attempt to reconcile credibility and flexibility at the world level. The aim of the agreements was not to reverse the shift towards purely fiduciary money, which had gained momentum in the period between the two world wars. Rather, it was to make the independent conduct of national economic policies compatible with the maintenance of stable international economic conditions.

Restricting short-term capital movements was an essential element.

The Bretton Woods system collapsed at the beginning of the seventies when the two conditions that had ensured its success in the preceding decades ceased to obtain: a balanced macroeconomic situation in the country issuing the reserve currency and national financial systems that were essentially closed, in the sense that capital mobility was limited and the monetary authorities exercised effective control.

Subsequent developments led to a credibility deficit, which contributed not a little to the high and persistent inflation of the seventies. Exchange rate flexibility restored the effectiveness of monetary policies in controlling inflation but did not prevent the emergence in the eighties and nineties of severe unemployment, economic stagnation and losses of welfare.

In the last few years determined and successful efforts have been made in the leading countries to restore orderly conditions and return to rigorous fiscal policies. The restrictive monetary policies pursued since the eighties have allowed a lasting reduction in inflation and a curbing of wage pressures. The conviction has grown that the internal and external value of each currency depends on the confidence of investors in the economy's ability to grow and prosper.

It is nonetheless wishful thinking to imagine that each country's "putting its own house in order" is sufficient to ensure stable economic and monetary conditions at the international level. An important part of the international banking system, and more generally of the financial markets, operates outside national borders. The quantity of money and credit created and exchanged is beyond the direct control of any national or international authority.

Uncoordinated national policies find it hard to stem the exuberance of the financial markets, to prevent the fluctuations in the prices of financial assets from imparting destabilizing impulses to the real economy. The high degree of financial and trade integration means that every country can be hit by the shock waves emanating from other regions, including those that are far off or apparently of limited economic significance.

Today's challenges echo the serious problems that the leading countries had to face in the early decades of this century as a result of the deepening of their domestic financial systems. The response to the instability produced by that, often chaotic, growth of banking consisted in the establishment of central banks as we know them today. This solution prevailed, however, only after it came to be generally acknowledged that money and credit were rarely able to reach an equilibrium endogenously.

The solution based on a strong central bank, free from political influence and endowed with considerable discretion is not practicable at the world level, however. The effectiveness and legitimacy of central banks are ultimately rooted in their being part of the state. At the world level the only road open is that of closer cooperation between national institutions and a strengthening and redefinition of the role of those established at Bretton Woods.

2. Imbalances in the world economy and monetary developments

The global market has created new opportunities to achieve welfare and prosperity for countries that lack capital and finance. It frees individual economies from the constraint of having to match saving and investment in each period. It allows intermediaries to hunt out the most profitable investment opportunities throughout the world, thus making for a more efficient allocation of saving. It results in the actions of policy-makers being subject to continuous scrutiny.

However, the risks of instability are enormous.

The possibility of financing imbalances may cause their correction to be put off. Sudden switches in investors' expectations lead to rapid shifts in their portfolios, thereby creating disruptive pressures in foreign exchange and securities markets.

The increase in international liquidity engendered by the expansionary stance of monetary policy in one or more of the leading countries normally leads to a fall in interest rates everywhere and stimulates economic activity. But at the same time it fosters the persistence of imbalances.

The ample availability of financial resources fuels a rapid expansion of credit that contributes to a deterioration in loan quality in banking systems that are not adequately regulated and managed; it encourages the taking of speculative market positions, which may lead to prices of financial assets that are inconsistent with economies' fundamentals.

The large and persistent balance-of-payments disequilibria of both industrial and emerging countries are the underlying cause of international capital movements.

The external accounts of the United States have been in deficit since 1983. Since 1990 the shortfall on current account has averaged around 1.5 per cent of GDP; this year it is expected to rise to 2.7 per cent of GDP owing to the differential in the rate of growth in domestic demand compared with Europe and Japan and the crisis in Asia. Japan's surplus has averaged around 2.3 per cent of GDP in the nineties; it will rise this year, probably reaching 3 per cent of GDP.

The two leading economies have consequently accumulated very large imbalances in their net external positions. At the end of 1997 America's debtor position, including its gold reserves, amounted to $1 trillion, or more than 12 per cent of GDP; Japan's creditor position was of the same size in absolute terms.

Large deficits developed in the external accounts of some emerging countries and areas in the nineties and were one of the underlying causes of the crises that occurred. The deficits of Indonesia, Korea, Mexico and Thailand rose to between 3 and 8 per cent of their respective GDPs; current account deficits have grown to a worrying size in some East European and Latin American countries.

Fueled primarily by private finance, the industrial countries' capital inflows and outflows increased by around 50 per cent in the nineties compared with the previous decade. At the same time the inflows to the non-industrial countries tripled and in 1996 were a shade less than $400 billion.

The proportion of the flows consisting of portfolio investment rose; in 1996 the inflows of this component to the industrial countries amounted to $900 billion, the outflows to $600 billion. The short-term and often speculative nature of such investment means that it is marked by greater variability and reactivity.

The stock of outstanding international bonds exceeded $3.3 trillion at the end of 1997. Encouraged by the fall in long-term interest rates, issues last year rose to a new peak of more than $800 billion, despite the slowdown that occurred following the outbreak of the Asian crisis.

The dollar remains the currency in which the bulk of these securities are denominated, accounting for more than one third of the total in the nineties. The proportion denominated in yen has declined; that in marks has risen to nearly 15 per cent. As the euro becomes established Europe's role in global finance will increase.

For the banks of the countries reporting to the Bank for International Settlements, claims on non-residents grew by 50 per cent compared with 1990, rising to $9 trillion. International loans contribute to the carrying out of major investment projects, support the operations of multinational firms, and assist research and the implementation of more efficient combinations of the factors of production. The financial component nonetheless remains preponderant: more than two thirds of the banks' claims on non-residents had another intermediary as the counterparty.

Interbank activity is a major factor in the multiplication of international liquidity, which, not being subject to direct control by any monetary authority, can expand to the point of creating financial turbulence and inflationary pressures. The cross-border component of overall liquidity, including interbank deposits, is very large, accounting for around one third of the total.

Institutional investors have been the driving force in the development of global finance in recent years. Their aggregate balance sheet has grown by more than 10 per cent a year. The volume of funds they intermediate is estimated at around $28 trillion, the annual output of the world economy.

These intermediaries raise liquidity in the markets where it is abundant and least costly. The composition of their portfolios is decided in the light of the expected risks and returns of a very wide range of investment opportunities, including those offered not only by the leading markets and currencies but also by emerging markets, less widely used currencies and complex financial instruments.

This makes a decisive contribution to unifying the market for finance. It leads to greater uniformity in the movements in financial asset prices across countries and links them more closely to the decisions of a number of leading players.

The trend and fluctuations of interest rates in the key money markets are transmitted worldwide.

Japan’s growing surplus with the rest of the world is matched by a deficit for the other countries, above all the United States. The *ex post* equality of saving and investment does not determine a particular level of interest rates.

It is the *ex ante* shortfall in investment compared with potential saving that is responsible for the current slowdown in economic activity.

Whereas a steady monetary policy stance has prevailed in the United States, Japan’s central bank has pursued an aggressively expansionary policy. Money market rates are close to zero but domestic demand is not reviving in Japan. It is a classic liquidity trap, involving a depreciation of the yen, a worldwide reduction in interest rates and a rise in share prices in the United States and Europe.

The weakness of effective demand and the measures taken to consolidate the public finances in all the major countries are preventing the excess of liquidity from translating into inflationary pressure.

Between 1990 and 1997 the notional value of exchange-traded derivative instruments, primarily interest rate futures and options, grew six-fold to exceed $12 trillion. Even more rapid growth was recorded for over-the-counter instruments, particularly interest rate swaps: between 1990 and 1996 those regularly reported to the Bank for International Settlements increased eight-fold to more than $25 trillion. The total notional value of derivative finance, that is the amount potentially able to influence the prices of financial assets, can be estimated at around $60 trillion.

Derivative instruments make it possible to manage complex risk positions, thereby broadening investment opportunities, increasing the scope for portfolio adjustment and enhancing the ability to protect wealth against adverse variations in securities prices and exchange rates.

The complexity of certain financial derivatives can make it hard even for investors to estimate their overall exposure to risk, especially when the size and simultaneity of the movements in financial asset prices are unprecedented. In order to safeguard the soundness of intermediaries, supervisory rules, adopted in part pursuant to international agreements, impose the use of procedures for correctly measuring credit and market risks. Adequate capital is necessary but it is not sufficient; it must be coupled with carefully designed internal controls.

Derivative finance facilitates trading, the working of markets and the pricing of financial assets. Where expectations concerning future movements in asset values converge, it may amplify the fluctuations of exchange rates and securities prices.

3. The recent crises

With an international monetary order lacking an overall system of governance, numerous currency crises have occurred. In particular, the breakdown of the European Monetary System in 1992-93 showed how difficult it is for fixed exchange rate regimes to work in the present context of integrated markets and highly mobile capital.

Since 1980 the banking systems of more than 130 countries have been beset by acute difficulties.

The interaction between currency crises and banking crises has become pronounced in recent years. “Twin” crises have occurred in the Nordic countries, Mexico and the Asian countries. In the most serious cases, the entire economic and financial system was shaken.

The immediate cause has often been the sudden withdrawal of finance from abroad as a result of international investors losing confidence in firms and banks.

The ultimate causes lie in the shortcomings of macroeconomic policies, in the structural weaknesses of financial and banking systems and in inadequate prudential supervision.

The recent Asian crisis is emblematic of how the combination of borrowing abroad and a structurally fragile banking system aggravates the consequences of failure to correct macroeconomic imbalances. The enormous capital inflow made it possible for large current account deficits to be maintained and provided the banking system with the means to finance investments offering low returns, with a consequent deterioration in loan quality. The excessive build-up of debt inevitably brought on the crisis.

4. The challenges ahead

The present configuration of international monetary relationships has no parallel in history. Never before have purely fiduciary currencies coexisted with such a high degree of capital mobility, vast global markets beyond the direct control of the authorities, flexible exchange rates between the major currencies and far-reaching economic integration.

The need to promote adequate forms of international cooperation on institutional structures, economic policy-making and specific measures to safeguard market stability has become urgent in the new context.

In order to restore orderly conditions during the Mexican and Asian crises, the international community made a financial effort of unprecedented proportions. Such an effort would be difficult to repeat.

In the past, the primary concern was that borrowers, often sovereign states, might come to have excessive expectations concerning international protection against the risk of insolvency. The recent crises have reminded us that it is just as important to promote prudent and far-sighted behaviour on the part of creditors.

The creation of an international bankruptcy law or the rapid convergence of national practices and regulations are currently beyond our reach. Nevertheless, there is ample room for improving the existing situation.

We must return and give new vigour to the work begun within the G-10 in the wake of the Mexican crisis on the introduction of contractual clauses to facilitate negotiations between creditors and debtors in crises and the possibility of temporary suspensions of foreign debt servicing in particularly serious situations. Under the vigilant eye of international institutions, such suspensions may prove necessary to allow debtors to formulate a credible adjustment plan and creditors to make a more considered assessment of creditworthiness.

It is important to enhance the soundness of national financial systems, fill the gaps in banking regulations and generally increase the effectiveness of supervision.

There is growing awareness that capital mobility is not a good in itself, an end to pursue without conditions or caution. The main lesson of the Mexican and Asian crises is that when opening up the financial system, it is necessary to ensure a stable domestic environment by strengthening the technical aspects of supervision and prudential controls, with complete independence from political influence. The International Monetary Fund now tends to pursue the more pragmatic objective of ensuring an orderly process of liberalization.

The Basle Committee for Banking Supervision has developed a number of core principles, a set of standards of proper conduct that countries must incorporate in their regulatory systems. The G-10 has proposed their extension to the emerging economies.

The most urgent requirement in dealing with the recurrent risks of endemic or systemic instability is to extend and strengthen action to prevent instability and make effective instruments available.

The first requirement for such action is that information on economies be timely, transparent and reliable. But it is also necessary to interpret, with reference to well-tested models that are also appropriate and sufficiently innovative, the behaviour and prospects of economic systems in which macroeconomic variables, prices, exchange rates, financial variables and structures, and political or administrative measures interact to produce stability and growth or instability and crisis.

Interpreting economic situations may prove too complex for financial intermediaries and investors despite the wealth of data in their possession. They therefore tend to follow leaders, moving in herds and swinging abruptly from pessimism to optimism, both of which are exaggerated and ultimately irrational.

Events in Mexico and the Asian countries are exemplary in this respect. A number of clear signs of macroeconomic imbalance, consisting in repeated large current account deficits and rapidly expanding foreign debt, together with the inefficiency of markets and intermediaries, certainly indicated that conditions were at least conducive to the development of a crisis.

The guarantees that in several cases the political and monetary authorities provided for loans contracted by firms and banks abroad are indicative in such circumstances of a situation of precariousness and in practice to no effect since the entire economic and institutional system is involved in the crisis.

It is important to reinforce the Fund's analytical capabilities and give it a more open and direct advisory role where countries are prone to crises. In other words, the Fund should have a role similar to that performed by national central banks in individual countries. We must address the problem of permanently strengthening the Fund's resources, to be used for "lending of last resort", with penalty rates of interest and stringent conditions attached.

It is being debated whether the Fund's opinions should be made public. Some fear that publication might jeopardize the confidential relationship between the Fund and government authorities or even trigger the crisis. If surveillance and analysis and the assessment of economic policies are carried out systematically, extended to many countries and based on recognized intellectual authority, such concern is unwarranted.

The strengthening of the Fund must be accompanied by the assignment of a larger role to the World Bank in the systematic monitoring of conditions in the banking and financial systems of the developing countries and the economies in transition in order to reinforce them and forestall instability that could originate in these sectors.

The challenges facing us are difficult but not impossible.

Earlier in this century financial instability appeared to have gained the upper hand, but an intellectual effort and a reforming drive made it possible to take the necessary counteraction and return to the path of stable growth.

Awareness of the enormous economic, political and social costs that endemic financial instability on a global scale inevitably entails must guide us in meeting the challenges.