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Conference on

International banking and financial systems: evolution and stability

Finance, stability and growth

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In the closing decades of the nineteenth century and up to the First World War the gold standard achieved a sort of de facto worldwide monetary unification. As Milton Friedman put it, "… the gold standard from 1879 to 1914 … came very close to being a unified currency".

Then, as now, advances in telecommunications were accompanied by the development of an international capital market.

Underpinning the system was the widespread acceptance in all the world's economies of flexibility in prices, costs and the main macroeconomic variables. Government budgets were small.

After the Great War, in the second half of the twenties, the restoration of the link with gold proved short-lived. The system entered into an irreversible crisis with monetary disorders and a tendency for all countries to put obstacles in the way of international trade and the circulation of capital. Detailed regulatory systems were introduced for banking and finance in all the industrial countries.

After the Second World War the construction of a new international monetary order based on the Bretton Woods agreements created the conditions for the world economy to enjoy a long period of rapid growth and stability. The Treaty of Rome and the return to convertibility of the leading currencies in the late fifties, together with the start of trade liberalization within the GATT framework, opened a prolonged period of trade expansion within Europe and in the rest of the world.

In the early seventies, the collapse of the Bretton Woods system was followed by a floating exchange rate regime.

From the mid-eighties onwards, partly as a consequence of the advances in information technology and the deregulation of banking, international financial intermediation and banking surged, outpacing both the expansion in world trade and the growth in economic activity.

In contrast with a hundred years earlier, when the system remained firmly anchored to gold, the growth in lending and capital movements of the last few decades has been based on purely fiat money.

The rapid expansion of the global credit and financial market makes it possible to channel savings towards the countries where investment opportunities offer the highest returns. It helps to allocate available resources according to standards of efficiency. By easing the constraints imposed by scarce savings, it fosters capital formation and growth.

In a similar context credit expansion and money creation are no longer bound at the global level by stringent rules.

New problems are posed for the stability of intermediaries and markets, with major implications for prices and the growth prospects of the world economy.

1. Banks' international expansion

The expansion of banks' international activity in the nineties was achieved by means of acquisitions of minority and controlling equity interests in foreign intermediaries, growth in foreign lending and fund-raising, and the opening of branches abroad.

This trend arose first of all in response to the growing international business of industrial and commercial firms, as the latter expanded, in part through mergers and acquisitions.

According to Thomson Financial, in the second half of the decade there were 19,400 mergers and acquisitions among industrial, commercial and service firms in the Group of Ten countries, Spain and Australia. The total value of such operations jumped to $3.8 trillion, from $550 billion in the first half of the decade. The acceleration was sharpest in the United States and the United Kingdom, owing to their highly developed financial markets.

In banking too, there has been a surge in merger and acquisition activity, above all within national systems. Banks have moved into new areas of business and enriched their range of products, especially in the field of asset management.

In the second half of the nineties, mergers and acquisitions between banks accounted for 10.1 per cent of the total number of M&As and 18.2 per cent of their value. By number, the share of banking M&As ranged from a low of 3 per cent in the Netherlands to a high of 16.1 per cent in Italy. By value, the share ranged from 3.7 per cent in Germany to 46.3 per cent in Italy and 65.6 per cent in Japan. M&A activity was more substantial in those countries where the banking system was initially more fragmented. In some countries these operations were encouraged by the supervisory authorities; in some cases they were the result of action to remedy situations of inefficiency or cope with bouts of instability.

The number of international mergers and acquisitions in banking was limited, in the nineties, compared with domestic operations. Cross-border operations are hampered, among other things, by the difficulty of estimating the actual value of foreign intermediaries.

The language barrier and cultural and regulatory differences tend to result in higher costs and operating inefficiencies. The expansion of banks abroad was achieved, in the nineties, largely through the acquisition of equity holdings, including minority stakes, by the biggest banks located in the countries with the most highly developed credit markets. In deciding where to invest, the important considerations have been countries' prospects for growth and the possibility of profit offered by the restructuring of the target banks.

For the G-7 countries, the portion of bank equity controlled by foreign shareholders in 1998 was 11.3 per cent in the United Kingdom, 8.2 per cent in Italy and 5.5 per cent in Canada. At the same time it was 5.2 per cent in France, 3.7 in the United States, 2.5 in Germany and 0.5 in Japan.

Foreign banks brings new skills, fosters product innovation and heightens competition.

According to the Bank for International Settlements, the foreign loan assets held by the banks located in the OECD countries and the main off-shore centres nearly doubled during the nineties, to stand at more than $10 trillion in September 2000.

International lending has grown very rapidly, despite its involving higher costs and greater risks than domestic lending. For the G-7 countries, banks' lending abroad rose from 34 per cent of their domestic lending in 1990 to 40 per cent in 1999.

In all countries the amount of funds that residents held in foreign banks increased considerably.

There are discernible patterns of specialization in banking flows. Three quarters of Japanese banks' lending to the emerging economies is directed to Asia; over half of such lending by US banks is directed to Latin America; 40 per cent of that by German banks goes to Eastern Europe.

In the industrial countries, cross-border lending to non-bank customers has been spurred lately by the economic expansion. The exceptional volume of loan business recorded in the first quarter of 2000 largely reflected the demand for funds from telecommunications firms. Banks operating in the City of London have played a prime role internationally, acting as the leading financiers of firms in the euro area and in the United States.

The succession of transfers from initial depositors to final borrowers has multiplied interbank flows. In the first quarter of 2000 interbank lending in the OECD area rose by $330 billion, as against $50 billion in new lending to non-bank customers.

2. The integration of financial markets and monetary policy

The activity performed by banks at the international level and the development, integration and orderly functioning of financial markets are essential for the growth and stability of the world economy.

However, the increase in borrowing by the non-financial private sector and the growing prominence in banks' balance sheets of exposures subject to abrupt adjustments can create situations of vulnerability.

To the extent that large financial enterprises hold significant positions in a multiplicity of markets and countries, shocks that once would have been confined to a single market now tend to spill over into other systems. The interdependence of economies is increasing, the speed at which the effects of national economic policies are transmitted is accelerating.

Since the mid-nineties expansionary national monetary policies have contributed decisively to the growth of international liquidity.

Money and other liquid financial assets, mainly bank liabilities, have grown more rapidly than output. Between the end of 1994 and the end of 1999, in the leading economies the broadest monetary aggregates increased from 68 to 71 per cent of GDP; liquid assets, which include interbank accounts and cross-border deposits held by households and firms, expanded even more rapidly, rising from 88 to 95 per cent.

In the three years from 1995 to 1997, international banking activity was stimulated by the significant monetary expansion implemented in Japan, initially to counter the excessive appreciation of the yen, subsequently to stimulate economic growth and enable the banking system to surmount its difficulties. Rather than sustaining domestic demand, this expansion translated above all into capital outflows, fostering purchases of bonds and equities by highly-leveraged institutions operating in the global market, who were able to procure low-cost funds and then invest in the main financial markets. The net outflows of bank capital from Japan were substantial, totaling $230 billion over the three years.

In the emerging countries of Asia, rates of growth in the money supply were much higher than those of GDP; between 1994 and 1999 the ratio of the two variables rose from 50 to 74 per cent.

The increase in international liquidity produced a generalized fall in interest rates, thereby boosting economic activity.

In the United States, GDP grew by an average of 4 per cent a year in the second half of the nineties. The powerful growth of investment helped to increase labour productivity. The rise in profitability fueled the rise in share prices.

In the emerging economies of Asia, the average annual growth rate, which had been 7.1 per cent in the eighties, rose to 8.1 per cent in the first half of the nineties and 8.6 per cent in 1995-96.

However, the possibility of financing imbalances caused their correction to be delayed.

The enormous flow of capital to the emerging countries of Asia made it possible to maintain large balance-of-payments deficits and supplied the banking system with resources to finance investments offering low returns. The excessive build-up of debt paved the way for the crisis. The links between banking groups and industrial firms often impeded efficient allocation of the funds raised on the international market; the profitability and stability of major intermediaries were compromised. In several countries regulation proved inadequate to stem excessive risk-taking.

The fall in demand in Japan in mid-1997 and the sudden change in expectations provoked rapid capital outflows, currency depreciation and a fall in stock prices in the countries of Asia.

The financial support provided to the crisis-stricken economies by the international community allowed the strains to be overcome, thereby facilitating economic recovery. A fundamental contribution came in the autumn of 1998 with the easing of monetary conditions by the Federal Reserve.

Massive volumes of funds, which had been withdrawn from the areas in crisis, headed towards the United States, attracted by the efficiency of US stock markets and the prospects of good returns on investment; between 1996 and the third quarter of last year, the overall net capital inflow amounted to around $1.2 trillion; portfolio investment accounted for more than four fifths of the total. In the two years 1998-99 there were also substantial direct investment inflows amounting to more than $160 billion, three quarters of which came from the euro area.

3. Asset prices and the stability of intermediaries

Recent analyses confirm that monetary policy impulses in the leading countries also impact heavily on the stock markets of other economies. For the major industrial countries as a whole, growth of the money supply in excess of nominal GDP is positively correlated with rises in share prices.

In the G-10 countries the total value of financial assets — consisting of money, bonds and shares — rose from 2.4 to 3.6 times the area's GDP between the end of 1994 and the end of 1999.

Between 1995 and the start of last year share prices in the US and European markets more than tripled. The abundance of liquidity and credit, augmented by international banking operations, helped drive prices away from values consistent with the economic fundamentals for prolonged periods.

Real estate prices also rose considerably in a number of countries. Between 1995 and 1999 house prices rose in real terms by more than 25 per cent in Scandinavia, the Netherlands and the United Kingdom, and by 76 per cent in Ireland. In the United States the increase in the same years was about 10 per cent.

In some countries the rise in real estate prices came in the wake of downturns in the first half of the nineties; in others the relative prices of houses were the highest ever recorded.

Fluctuations in share and real estate prices can affect the solidity of financial intermediaries, particularly banks.

According to the IMF, the growth in the world economy is likely to slow from 4.7 per cent in 2000 to around 3.5 per cent this year. Factors of instability accumulated in the past are beginning to emerge.

In the United States the signs that the economy is cooling and the downward revision of firms' profit forecasts have brought a sharp correction in share prices in the high-technology sector. Firms listed on Nasdaq have lost some 60 per cent of their value since last spring.

In recent months the risk premium on private bond issues has risen again, especially for borrowers with lower credit ratings. The worsening conditions in the US capital market led to higher demand for bank loans. Recent surveys by the Federal Reserve show that the major banks have tightened their credit standards and terms.

The American banking system still enjoys a high return on equity despite loan write-offs by some major institutions.

In Japan in 1998, when the weakness of the banking system threatened a major crisis, the authorities had allocated an amount equal to 12 per cent of GDP to sustain the banks.

With the economy slowing again, the difficulties of credit intermediaries have become more acute. Banks are still burdened with a large volume of bad debts, and their profitability remains low. Their own estimates for the end of last March indicate total bad debts and non-performing assets in excess of ¥63trillion, compared with capital of ¥45 trillion.

The government has announced that it will present a plan for the accelerated writing-off of unrecoverable loans.

The Japanese economic and financial system still has a net foreign creditor position vis-à-vis the rest of the world, equal at the end of 1999 to $830 billion, or 16.5 per cent of GDP. The industrial reorganization now under way is intended to strengthen firms' productivity; it fosters capital formation.

In Argentina the tensions in the financial market of the second half of last year, generated by a worsening economic situation, deflation and political uncertainty, caused the spread between yields on dollar-denominated government bonds and US Treasury paper to widen by 5 percentage points. Following intervention coordinated by the IMF and the easing of monetary conditions in the United States the spread narrowed in January. It now stands at around 6 percentage points.

In Turkey, the crisis, which had resulted in the failure of several Turkish banks at the end of last year, badly affected the stock market and yields on government securities; pressures on the lira were countered by drawing on official reserves. The cost to the public purse of support to the banking system was estimated at $6 billion, or

3 per cent of GDP. More recently, political tensions triggered an abrupt decline in the stock exchange, an increase in money market rates and a sharp depreciation of the currency. The overall exposure of international banks to Turkey amounts to $43.6 billion.

In Europe the fall in share prices was accompanied by an increase in the premium on private-sector bonds and syndicated loans. The banking system suffered an increase in funding costs, which was smaller than that in firms' borrowing costs. Thanks partly to the good performance of the economy, the system's earning capacity is holding up.

4. The protection of financial stability

The Basel Committee has set forth principles for effective banking supervision, especially in emerging countries. The Committee, in cooperation with the International Monetary Fund and the World Bank, has developed methods for evaluating the adequacy of individual countries' banking supervision. The G-7 countries will have their own systems evaluated as part of this exercise.

The Basel Committee has produced guidelines to improve banks' corporate governance and internal control and risk-management systems, especially with respect to credit risk.

The 1988 Capital Accord, which was subsequently extended to cover market risks, had already contributed to halting the long-term erosion of banks' capital and reserves. Since its introduction, international banks' risk-weighted capital ratio has risen on average by more than 3 percentage points to 12 per cent.

The New Capital Accord, which will come into effect in 2004, entrusts the prevention of bank failures to a set of measures hinging on more widely diversified capital requirements, rigorous procedures for controlling banks' capital adequacy in relation to the risks they assume and the strategies they adopt, and more effective market discipline.

The possible elements of vulnerability in the international financial system are being analyzed by the Financial Stability Forum, which was set up in 1999 at the initiative of the Finance Ministers and central bank Governors of the G-7 countries to propose corrective measures capable of preventing systemic instability.

The Forum has issued recommendations designed to prevent crises arising from the operations of highly-leveraged institutions and called on supervisory authorities to take account, when authorizing their intermediaries to operate in off-shore centres, of the extent to which these adhere to the supervisory rules and best practices of the international financial community. In recent months the IMF has begun its programme to assess the adequacy of off-shore centres' supervisory systems and their compliance with international standards.

In the European Union, directives lay down common prudential rules and ensure a level playing field for all intermediaries.

Banking supervision benefits from close cooperation between the authorities of the different Member States on the basis of procedures agreed bilaterally in memoranda of understanding. The cooperation between authorities follows intermediaries in every stage of their activities, from entry into the market to expansion into new geographic areas to the resolution of crises.

Fora for multilateral cooperation are envisaged to address issues connected with legislation and discuss problems concerning individual intermediaries. Analyses of a macroprudential nature are conducted regularly within the European System of Central Banks.

In implementing the common monetary policy, account is taken of interventions of national authorities in connection with liquidity crises at individual intermediaries.

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Stable and efficient banking systems are instrumental to the protection of savings, the financing of investment and the growth of the economy.

The report on Consolidation in the Financial Sector prepared under the auspices of the Ministers of Finance and central bank Governors of the G-10 countries is a fundamental source for analysis of the efficiency and stability of banking systems.

Fund-raising and lending are still centred on national markets, even in the case of larger intermediaries. Risks of instability transmitted from international markets must be countered and circumscribed through adequate supervision.

Effective supervisory action and the prevention of instability require the direct and timely supply of detailed information, closeness to the institutions supervised and knowledge of the environment in which they operate.

Supervision is necessarily rooted in national legal systems owing to the close relationships between its tasks and public and private normative institutions, the system of deposit insurance and the possible repercussions of insolvencies on the public finances. It is linked with other institutional bodies and participates in more and more advanced forms of worldwide cooperation.

The surge in share prices in the autumn of 1999, which saw technology stocks rise nearly twofold in just a few months, reflected expectations of very high earnings growth. Although possible for a limited number of firms, this scenario was not realistic for the market as a whole. Even for shares in traditional sectors, the risk premium was low by historical standards.

The sharp fall in the prices of technology stocks shows again that risks can be very substantial even in the case of firms with high rates of expected earnings growth. Despite the downturn, in traditional sectors the price-earnings ratio remains higher than its long-term level of the past. The greater efficiency and increased depth of the markets are beneficial.

The abundant supply of international liquidity can help to prevent a collapse in share prices. Looking beyond the short term and the difficulties of the moment, the revival of demand in the United States, the persistence of rapid growth in Europe and the recovery of the Japanese economy will be decisive.

In Japan, it is necessary to move ahead with reforms that will enable the economy's enormous productive potential to respond more effectively to domestic as well as international demand.

In Europe, a stimulus to growth and employment will come from structural measures for the labour market and the social security and public health systems, together with a gradual but certain reduction in the tax burden. In the long term, a contribution will come from the expansion of trade and the better utilization of human resources connected with the enlargement of the European Union to the countries of Central and Eastern Europe.

The potential growth rate of the United States remains high: it is estimated at about 4 per cent a year. The announced transfer to households and firms of part of the large budget surplus expected over the next ten years, targeted increases in public spending and a careful monetary policy may bring the actual increase in output and income into line with the potential rate of growth.

The Americas and the world economy will benefit as a result.

Economies have become increasingly interdependent. Efficient and stable financial markets are now an essential factor in economic development.

The increased cooperation, especially in the financial field, among the advanced countries and with the emerging economies enhances the ability to control the evolution of the world economy. It fosters growth, to the advantage of all.

Thirty years after the collapse of the Bretton Woods system, it is necessary to define the criteria and rules for the construction of a new international monetary order. In a setting that lacks a monetary anchor, it is necessary to couple the attention given to the operation of markets and intermediaries with a renewed analytical focus on money and the international expansion of finance.