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FINANCIAL MARKET INSTABILITY: CAUSES, IMPLICATIONS AND REMEDIES

Report of a Meeting of Management Experts held under
the Labour/Management Programme

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FINANCIAL MARKET INSTABILITY: CAUSES, IMPLICATIONS AND REMEDIES

Report on a meeting of Management Experts
held under the OECD Labour/Management Programme

(Paris, 22 and 23 April 1991)

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SUMMARY

Under the OECD Labour/Management Programme for 1991, a meeting of Management Experts on "Financial market instability: causes, implications and remedies" was held in Paris on 22 and 23 April 1991. This meeting was prepared in collaboration with the Business and Industry Advisory Committee to the OECD (BIAC).

Following the major and unforeseen fluctuations on world financial markets in recent years, this meeting was designed to give management experts an opportunity to discuss what were the primary causes and what in their view were the implications for investment strategies and financing (portfolio and direct), attitudes regarding risks (exchange rates, interest rates and others), debt management, macroeconomic policy, etc. A third topic discussed was management experts' ideas for policy responses to instability.

The attached report, which is a general summary of the discussions of the meeting of experts, has been drafted by M. Christian de Boissieu, Professor at Paris I University (Panthéon-Sorbonne), (France), who was the general rapporteur.

A list of participants is attached in annex.

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FINAL REPORT ON THE MEETING

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Introduction

Financial market instability today reflects not only excessive interest rate and exchange rate volatility but also the fragility of the financial institutions.

Above what threshold may the volatility of financial asset prices and interest rates (or exchange rates) be deemed "excessive"? A difficult question to answer, for in a market economy interest rate changes are part and parcel of adjustment. These changes can be contained within strict bounds only by employing cumbersome and ineffective quantitative controls. In practice, volatility may be termed excessive when it has the effect of pushing security prices way out of line with "fundamentals" (as more or less conventionally defined and measured) -- raising such topical issues as speculative bubbles and exchange-rate overshooting -- and/or of generating systemic risks.

The fragility of the financial institutions has, over the recent period, taken extreme forms in the United States with the collapse of the savings and loan associations. Fortunately in a less extreme form, US, Japanese and European banks, inter alia, have also been affected and this has been reflected in smaller profits, poorer-quality bank portfolios (with country risks, reasonably covered or just about, being relayed by domestic risks), and accelerated restructurings, etc.

Market volatility and the vulnerability of financial intermediaries are becoming ever more closely intermeshed, as a result of the growth in banks' market activity and the actual or potential consequences for bank profitability of capital losses on securities. The consequences were considerable after the maxi-crisis of 1987 and the mini-crisis of 1989, as more recently for Japanese banks in the wake of the Tokyo stockmarket plunge. Conversely, dwindling profit margins are likely to influence banks' market behaviour and hence market equilibrium. In a world where transactions are global, financial market instability has something in common with a game of musical chairs since, depending on circumstances, it can take the form of extreme volatility of financial asset prices, stockmarket crises and bank default.

One important point which constantly cropped up in the debate deserves mention. Financial instability is not necessarily a bad thing. It is inevitable and in some ways useful in that it mirrors the financial risks and the risks of the real world. It becomes harmful only when speculative behaviour assumes such proportions that volatility (e.g. exchange-rate volatility) gets out of hand. It is also a sign that financial systems are living, changing organisms. It is part and parcel of the process of transition from one type of financial equilibrium to another.

Discussion focused first on the causes and implications of financial stability and then on possible remedies.

1. The causes of financial market instability

1.1 The issues

Any consideration of financial market instability must take some account of international as well as national disequilibria, particularly budgetary disequilibria.

It is widely agreed that the configuration of disequilibria (current surpluses and deficits) was instrumental in triggering the 1987 stockmarket crisis. Under the impact of deregulation, capital has become the most internationally mobile factor, far more so than goods or labour. This seems likely to continue. On the assumption of perfect capital mobility, the adjustment between current surpluses and deficits is smoother, but at the same time a tiny news item is liable to spark off large-scale capital transfers and an overreaction of exchange rates and/or interest rates. Since 1987, current balances have adjusted significantly: the US deficit now accounts for a much smaller proportion of GNP; the German surplus has all but disappeared as a result of unification. Only Japan has managed to maintain a current payments surplus but whether it can cling on to it in the coming years is a moot question. Moreover, Japan has been and will remain at the mercy of domestic sources of financial market vulnerability and these could well have a fall-out effect on the world economy as a whole.

Public deficits generate chronic financial market instability and fragility in several ways: by diminishing, through government disinvestment, net total savings in a situation of shrinking private savings; by exerting pressure, by way of crowding-out effects, on interest rate levels and volatility. The pace of fiscal adjustment varies across the OECD area; it is slower in the United States, faster in France, while German budgets are of course temporarily overshooting owing to unification.

Inflation, which in itself expresses all the various disequilibria, can also exacerbate financial market instability by clouding the transparency of indicators and signals and compounding uncertainty. Broadly speaking, when a new very different level of inflation is reached financial behaviour patterns may radically alter (e.g. portfolio behaviour) and hence a source of some short-run instability.

Whatever the type of disequilibrium -- budgetary or external -- the psychological effects can magnify the purely mechanical effects. The traditional warning effect is compounded by the growing difference between the time frame for economic adjustment which must necessarily be fairly substantial because of the lag in adjusting external and budgetary balances, and the time frame of market operators which is telescoped under the effect of financial market instability. There is in fact a link, for while the short-termism of market operators is a fairly good indicator of prevailing financial instability it can also worsen it.

The discussions only touched on the question of international disequilibria, dwelling rather more on the aims and results of international G7 co-ordination and on other forms of mismatch, notably that between financial globalisation and sophistication on the one hand and the delicate task of controlling a complex financial environment on the other.

1.2 Changes on the financial scene and instability

Financial market instability has obviously been exacerbated by the shift to floating exchange rates (March 1973) and by greater empirical interest-rate volatility, itself due to a variety of factors (central bank use of interest rates to manage floating currencies, the transition at differing paces from quantitative credit controls to regulation by way of interest rates, etc.). Has it also been made worse by the most marked changes in the financial scene (globalisation, deregulation, financial innovation, securitisation, etc.)? While the discussion did not dwell on this, several comments deserve mention:

- 1) Globalisation and the new telecommunications facilities speed the propagation in real time, around the clock, of financial (e.g. stockmarket) shocks.
- 2) Opinions on the impact of markets in derivative instruments (futures and options) on the variability of spot rates differed. Even though past experience may be cited as evidence, there is no proof that futures markets, for instance, make the spot market any more volatile. Overshooting of certain thresholds does appear to play a crucial role and similarly, in some circumstances, there does appear to be a trade-off between the liquidity of the spot market and that of derivative markets.
- 3) Financial innovation (variable rates, futures, options, swaps, etc.) does not eliminate individual risk. It simply redistributes it, from operators highly averse to risk to others less averse and even inclined to risk-taking. Even if, via these transfers, algebraic neutrality appears to prevail since "nothing is lost and nothing is created", the redistribution of individual risks cannot be economically neutral. For, with financial innovation to the nth degree, the financial system could well become more opaque, which in some circumstances could increase the systemic risks. In any case, financial innovation is not the cause (in the customary sense) of financial instability; at most and then not always it is an enabling condition (i.e. a factor allowing some causes to play a role or a stronger role).
- 4) On several occasions during the discussions, the issue of the trade-off between cost-effectiveness and financial stability arose. The new financial environment undoubtedly makes for more efficient allocation of saving and investment, though it often at the cost of making financial asset prices more volatile. This being so, the task of economic policy, and especially monetary policy and prudential supervision, is clear: to improve the efficiency-stability trade-off, though it obviously cannot be done away with altogether.

From this standpoint, policy innovations (especially as regards the monetary area and bank regulation) must adjust to systemic innovations, in order to maintain control over what have become highly sophisticated financial systems.

1.3 Transition and instability

The discussion on whether or not financial market instability is here to stay did not come up with any conclusions. Two fairly contrasting views emerged.

Some believed that greater market instability and the fragility of the financial institutions was mainly ascribable to the transition, in practical terms, from an overdraft economy based on the predominance of bank intermediation to a capital market economy based primarily on direct finance, as well as to the transition from one type of banking system equilibrium (with regulation, quantitative credit controls, cartellisation, etc.) to another type of equilibrium based on totally different properties (deregulation, regulation by way of interest rates, fiercer competition, etc.). According to this thesis, instability could be substantially reduced once the transition was over, particularly as economic agents become more used to handling risk.

For others, the greater instability derived from the changes, such as globalisation and the achievement of untrammelled capital movements, that are virtually irreversible (except in the event of major unforeseeable shocks). It was likely to linger on well after the transition. The discussions revealed how widely views diverged on this important question. Though no firm consensus was achieved, the following points are worth raising:

- 1) The notion of transition, today used in a variety of contexts (for instance with reference to German unification, the transition of the East European countries to a market economy, or economic and monetary union within the EEC) is ambiguous. Changes in the financial system is an ongoing process that will extend into the 1990s and beyond, even if not linearly.
- 2) Financial innovation demands a learning effort from the various operators. The techniques for securitising assets or proper use of derivative instruments (futures, options, etc.) for purposes of hedging or trading cannot be mastered in a day.
- 3) The profile of adjustment in the 1990s seems to be emerging more clearly. In the world economy, as at the level of the sub-regions (EEC, North America) capital looks set to continue to be more mobile than goods, which in turn will be more mobile than labour. Time and a great many structural measures are needed if labour mobility is to be changed at all significantly. Given the chronic nature of certain international disequilibria and the foreseeable limits to international co-ordination, the empirical volatility of exchange rates and interest rates is thus likely to remain high.

1.4 The time frame of economic agents

Here two aspects received special attention. The first, which has been touched on above, is the "shortsightedness" of market operators. The shortening of their decision-making time frame has manifested itself in several ways over the past few years: the success of liquid saving, the reluctance of businesses to commit funds for productive long-term investment, etc. This vicious circle is hard to break: the instability observed encourages a short-termism on the part of savers and investors which can only exacerbate the overadjustment of financial assets, exchange rates, etc.

The second aspect is the asymmetrical behaviour patterns of private and public operators. Is the short-termism of some private operators "offset" by a lengthening of public decision-makers' time-frame? This is a crucial point, and one to which it is difficult to reply on sound evidence. Several participants drew attention to the risk of "pollution"; the time horizon for government reflection and policy-making authorities would appear to have reflected, rather than offset, the trend in the private time-horizon. The same idea may be expressed by pointing up the potentially destabilising role of economic policy. Merely by looking at financial market instability since the mid-1980s, it is easy to find many examples of policies with a procyclical (rather than countercyclical) impact, the odd unfortunate remark triggering negative expectations, etc.

In economic analysis of financial market instability, it has become common practice to develop J.M. Keynes' intuitive thinking in Chapter 12 of his General Theory, in which he likens the stockmarket to a beauty contest: the important thing is to anticipate what the others will do and do it first, to the Nth degree. Mimetism of anticipation and behaviour patterns already occurs in "normal" periods. Taken to the extreme it becomes both a cause and a symptom of the financial crisis. Whereas the role of the authorities should always be to find a way of interrupting contagious spirals, in fact they make sometimes them worse.

1.5 Some comments on the disconnection between the real and the financial sphere

The connection between the real economy and the financial economy is often cited to explain and illustrate financial market instability. But convincing empirical studies are signally lacking. For instance, international comparisons of price-to-earnings ratios (PER) are not really meaningful, if only because profits are measured very differently across countries. Work in progress in France in the Conseil national de l'information statistique (CNIS) [which meets under the aegis of the Ministry of the Economy, Finance and the Budget], in co-operation with the central bank, has produced some preliminary conclusions:

- 1) GNP growth is probably a fair indicator of how the real economy is progressing in France, even though it takes no account, inter alia, of trade in intermediate goods and second-hand goods.

- 2) There are many more variables that could represent the development of the financial sphere, ranging from the amount of financial assets to the volume of stockmarket transactions and including the broad concept of the net flow of claims by non-financial agents. In all cases, the monetary aggregates, even broadly defined, are pretty poor indicators. Empirical studies covering the period 1978-1988 reveal that the disconnection of the financial sphere from the real economy is quite marked in the United States; that the French stockmarket is catching up with those of the English-speaking countries (obvious when one compares the expansion of stock-exchange transactions with GNP growth); and that Germany, won over to financial innovation only in 1988, has so far not suffered any significant disconnection (though this did not prevent the Frankfurt stock-exchange from plunging more steeply than exchanges in any other G7 country at the time of the 1987 stockmarket crisis).

2. The implications of financial market instability

2.1 • General comments

Financial market instability has two major effects on financial behaviour patterns which were simply raised without being discussed in any depth:

- a preference for liquidity. In a world of volatile interest rates, investors tend to prefer variable-rate and short-term investments, in order to limit the risks of capital losses. This trend is perceivable in most OECD countries and was particularly evident after the October 1987 and October 1989 crises. In one way the stockmarket crisis of October 1987 served as a lesson in that some enterprises and individuals that had tended to underestimate financial risks learned to assess them better. The preference for liquidity explains the continuing popularity of open-end investment companies and mutual funds, especially when financial market instability is coupled with an inverted or flat interest rate curve. Since 1988, the interest rate curve has been flat and even inverted in several major OECD countries right up to the time of this meeting in the spring of 1991. Financial globalisation, as has been seen, is compatible with quite markedly distorted interest rate curves, since the United States curve is firmly positive (a differential of 250 to 300 base points between long and short rates), those of France and Germany slightly negative (while in the United Kingdom short rates are still running ahead of long rates). These persisting differentials are probably explainable *inter alia* by differences in interest-rate expectations across countries, by differences in the credibility of monetary policy and disinflation across economies.
- a quest for quality. Financial market instability often heightens the risk of borrowers' defaulting. It is accompanied by a widening of spreads, distinguishing between yields on private securities and securities issued or guaranteed by central governments. This was

more obvious at the time of the crisis of October 1987 than that of October 1989. The quest for quality obviously has an impact on the situation of different borrowers: 1) Private borrowers, rationed on the markets, tend to turn to financial intermediaries, though without any assurance of obtaining the funds they want. There is an incontrovertible link between financial market instability on the one side, credit rationing by the banking sector and the credit crunch on the other. 2) The favour enjoyed by credible governments at times of financial instability may encourage them to relax fiscal constraint, and that would be an unwanted consequence of the quest for quality.

2.2 Impact on international trade

Have volatile and misaligned exchange rates seriously affected the growth of international trade?

On overall performance, it is hard to say. Since the early 1960s, world trade has been growing at roughly twice the speed of world GNP. And this elasticity does not seem to have been significantly reduced by the shift to floating exchange rates in March 1973. This, of course, does not prove anything, since it can always be claimed that the elasticity of international trade with respect to growth would have been over 2 had exchange rates been less volatile. This empirical finding could also suggest that companies have quickly learned to live with exchange-rate instability and have made widespread use of exchange-rate hedging techniques.

Several participants stressed the need to move beyond generalisations and approach the issue at the sectoral and microeconomic levels. The same or other participants nonetheless pointed out that exchange rate volatility is not necessarily entirely negative in that it can make it easier, in some instances, to penetrate foreign markets. One especially telling example occurred when the dollar was rising and overvalued (1980-beginning 1985), which had a catalysing effect on the penetration of the U.S. economy by foreign products and producers (from South-East Asia, but also from Europe). Because of the ratchet effect (which applies up to a certain threshold), this penetration did not suffer a setback when the dollar subsequently fell.

2.3 Effects of instability on the behaviour of non-financial agents

Management representatives were agreed on many points:

- 1) Because of their extent, suddenness and unpredictability, exchange-rate risks were considered to be much more worrying than interest-rate risks. The general impression was that companies just about manage to cope with interest-rate volatility but that, despite the existence of various hedging techniques, they are actually highly exposed to the consequences of misjudging exchange rate movements. Another related factor was that some companies are concerned about the long-term profitability (10 years, or longer) of their investments, whereas the hedges provided by the official or over-the-counter markets almost always have a short-term time frame. Another related issue, that was only touched on, may at least be flagged: namely the possible spread of volatility from foreign

exchange to financial markets and vice versa. Experience in 1987 suggests, though it cannot be formally proved, that by wishing to respect the target zones set for reference exchange rates in the presence of major international disequilibria, there is a risk of offloading part of the cost of the adjustment on to interest rates (i.e. on to the financial markets). It could be said that the 1987 crisis was the "love-child" of the Louvre agreements of February 1987 (even though it could be ascribed to other entirely unrelated factors as well). The moral of the story: even if reducing exchange rate instability is crucial for companies, this must not be done at the expense of the free flow of capital; priority must be given to redressing international disequilibria and seeking to anticipate the probable consequences for interest rate volatility.

- 2) The benefits companies derive from the new financial market developments (access to a greater variety of financing sources, a significant reduction in the cost of bank intermediation due to competition and disintermediation) must be set against the disadvantages associated with excessive exchange rate volatility. Management representatives stressed the uncertainty attached to the profitability of investment ventures when exchange rate risks are high. Exchange rate instability is a matter of concern even to firms whose activities are purely domestic inasmuch as their competitors may be either directly or indirectly affected by it. In the case of a major corporation such as Philips, direct investment in several countries is also a way of spreading exchange rate risks.
- 3) Many companies find themselves obliged to operate a trade-off between productive investment and financial investment. At microeconomic level, the choice depends mainly on the difference between the return on physical capital and the interest rate. Rising real interest rates combined with expectations of lower inflation (and hence a decline in nominal rates) probably favoured financial investment in the first half of the 1980s (purchase of open-end investment company and mutual fund units by firms). Real rates are still high in most OECD countries and are likely to remain so. But as a result of the stockmarket crises companies have learnt to appraise financial risks more accurately and to weigh them against the risks involved in productive investment. While it would be absurd to claim that financial market instability boosts productive investment, it has nonetheless diminished the excessive bias towards financial investment.
- 4) The cost of hedging exchange-rate risks is often high, but, in view of the scale of the potential losses, hedging makes sense. The discussion touched on, though in no great depth, the issue of the comparative costs and advantages of various hedging techniques (options, futures, etc.).
- 5) The implications of exchange-rate risks depend on the company's size and sector of activity. Several speakers drew attention to the special problems of SMEs, which are often ill-equipped to diversify and hedge their risks.

- 6) Practice has shown that it is sometimes hard to tell where ordinary activities end and speculation begins.
- 7) Financial market instability also has an impact on investment financing, both intermediated and disintermediated, as well as on the breakdown between self-financing and external funding. It will be remembered, for instance, that the 2 to 3 months following the October 1987 stockmarket plunge saw the beginnings of "reintermediation" on some domestic markets as well as on international capital markets.

2.4 Implications of financial market instability for the financial institutions

The internationalisation of the banking sector and its expanding market activities means that banks are far more exposed than in the past to exchange-rate and interest-rate risks.

The bank representatives, while pointing out that most financial institutions were making every effort to protect themselves from risk, stressed that reliable methods were hard to find and apply. The traditional techniques (duration, gap calculations, etc.) were employed. Along with what amounted to asset and liability management, many institutions were also developing interest-rate risk exposure measures that went well beyond traditional techniques. This should not only enable financial intermediaries to adopt a more reasoned and more active stance with respect to market risks but also facilitate prudential regulation in this area (see below).

3. Financial market instability: remedies and prospects

3.1. General comments

Financial market instability poses serious problems only when it generates systemic risks. How can individual risks (market-making risks, market risks, etc.) be differentiated from systemic risks? In practice systemic risk depends on the configuration of individual risks, but it adds another dimension due to contagion and copycat effects on behaviour (see, for instance, the analysis of bank "runs" and the globalisation of what were initially purely local problems). What systemic risk really means is the risk of a cumulative loss of confidence in a currency and in the financial institutions following a stockmarket crisis, bank defaults, etc. This confidence clearly amounts to a collective good. It is for the authorities to manage systemic risks in such a way as to contain them, even though the private sector is directly concerned by their presence and implications.

3.2 What action is awaited from the authorities?

There was a central issue in the discussions: in a market economy subject to financial instability, how far should central government intervene? Several aspects were discussed.

The need for information to be transparent

In seeking more transparent information and less asymmetry in the information available to lenders and borrowers, ethical considerations go hand in hand with a concern for cost-effectiveness. More transparent information makes for more efficient capital markets, as well as for better evaluation (and hence better containment) of individual and systemic risks. Here, participants noted the persisting mismatch in many countries between the sophistication and complexity of the financial system on the one hand and risk evaluation and risk containment on the other. To take two examples among many: 1) Banks are still exposed to some asymmetry of information inducing a cautious approach and possible credit rationing since, despite the information available, they have difficulty in assessing the profitability of schemes put forward by borrowers; 2) Agency rating is, in some countries, lagging behind the development of financial innovation and capital markets. And this disparity, denoting inadequate risk evaluation, must be rapidly made good not by withholding financing but through the establishment of reliable ratings.

Behind the quest for greater transparency of information lie other objectives: better protection for savings (along with better consumer protection), smoother operation of financial markets which implies tight constraints so as to safeguard transactions, secondary market liquidity, etc..

Prevention ...

To forestall and contain systemic risks, two main instruments are available to the authorities: deposit insurance and prudential measures.

The question of deposit insurance was raised though not discussed in any depth. The general sentiment was that the issue, a crucial one in the English-speaking countries and especially in the United States, was likely to come to the fore in continental Europe in the course of the 1990s, in view of the structural as well as cyclical trend towards lower profit margins and the scale of bank restructuring. The lesson should also be drawn from the US experience in the area of deposit insurance and measures taken to limit the extent of the moral hazard which played such a major role in worsening the situation of savings and loan associations.

The term prudential policy is used to designate the set of measures -- generally regulatory -- aimed at limiting the risk exposure of financial and non-financial agents and safeguarding capital market transactions. Some comments are in order:

- The 1990s will be a period of prudential control. Deregulation will be accompanied by stricter rules (with the strengthening of some regulatory mechanisms) with the object of containing financial market instability through the introduction of prudential measures. The process, set in train with the co-ordinated adoption by the Bank for International Settlements and the European Commission of the Cooke ratio, is proceeding apace. The international co-ordination initiated in Basel and Brussels in 1990-91 was primarily designed to hedge financial institutions' position exposure (or market exposure).

- The borderline between monetary policy and prudential control which, not so long ago only, appeared quite clear is becoming more and more blurred. The Cooke ratio, for instance, is first and foremost a prudential instrument designed to bring credit institutions' equity and quasi-equity in line with their total commitments (including their off-balance-sheet commitments). But it is also a means of re-examining the growth of bank commitments and cannot hence be seen as separate from monetary policy in its usual sense).
- The prudential ratios, while essential, necessarily have some unwanted effects that must be kept to a minimum. First, by squeezing profit margins, prudential ratios can prompt banks to go for more risky investments (this is one of the problems of the Cooke ratio which is precisely designed to contain the market-making risk of the financial institutions). Second, any regulatory measures elicit a response in the form of financial innovations to get around them (wriggling out of the constraints created by the regulatory controls). The same will happen in the case of the Cooke ratio and the measures about to be adopted with respect to the financial institutions' position exposure. The authorities must seek to anticipate what forms this evasion will take and limit its extent, while abiding by the rules of the market economy.

... or cure

The discussions reflected several major issues of concern to all operators, both private and public.

- In action by lenders of last resort (LLR), what place should be accorded to the difference between illiquidity and insolvency? While the distinction seems clear in theory and from a bookkeeping standpoint, it is by no means easy to apply. Only after the event is it possible to be wise -- yet the central banks, in deciding whether or not to act as lenders of last resort, have to make up their minds beforehand.
- How large should the LLRs' safety net be? Here too the response is based on experience rather than theory. While in principle, the central bank safety net is extended only to secondary banks and to them alone, financial market instability has impelled LLRs to ensure directly or indirectly, that investment banks, capital markets, etc. do not run into trouble. The behaviour of the US Federal Reserve Bank at the time of the October 1987 stockmarket crisis illustrates how the safety net works. Financial globalisation calls for a global intervention by LLRs. Here the current debate on the scope of the "too big to fail" argument becomes central. From the standpoint of managing systemic risks, central banks find themselves having to distinguish between tolerable defaults (tolerable because they do not generate any systemic risks) from other kinds of default. Size is deemed to be more important than the nature of the financial institutions, causing small banks to complain that they are being victimised by unfair competition (the stand adopted by the small

banks on the proposed US bank reform is indicative of this attitude). The issue of when and how the LLRs should intervene poses anew that of moral hazard. To limit the moral hazard, whether and how the LLRs will intervene must remain uncertain and the number of co-insurance mechanisms must be increased (with policyholders continuing to bear a proportion of the risk).

- Is management of financial market instability compatible with efforts to reduce inflation? In principle, it requires periodical cash injections that are liable to be pro-inflationary. In practice, the central banks must be admired for the dexterity with which they handled the 1987 and 1989 stockmarket crises, injecting funds (particularly in October 1987) to calm short-term movements, and quite rapidly withdrawing them again in one way or another in order to limit their pro-inflationary impact.

The role of international co-ordination and European integration

a) G7 co-ordination

While the economic and financial system is now a global one, policies have not yet acquired the same global dimension. International economic policy co-ordination, given new impetus in 1985, was designed, *inter alia*, to steady financial markets. It has been in some measure successful and it would be wrong to underestimate what has been achieved. International disequilibria have been partly redressed since 1989-90, with a rapid contraction of the United States' current payments deficit (as a percentage of US GNP) and of the German current payments surplus (in the wake of unification). Other achievements of G7 co-ordination have been progress on LDC debt (rescheduling giving way to debt relief from 1989, on the Brady initiative), and prudential policy (see above). There has been progress too in the area of multilateral supervision in the framework of the G7, with the establishment of fiscal and tax policy co-ordination and a shift from an *ex post* approach to one of *ex ante* analysis of the compatibility of national economic policies. But on two issues of direct concern to the corporate sector, performance remains disappointing:

- Despite the reduction in exchange-rate volatility with respect, since the Louvre Agreements, to the target bands, rates are still liable to fluctuate sharply and misalignments still persist. Central bank intervention, even co-ordinated, on foreign exchange markets cannot, in the medium and long run, change the fundamentals, even if in the short run it might do some good as a warning signal. More generally, quite considerable co-ordination -- implying some relinquishment of national sovereignty -- is needed for relative exchange-rate stability and perfect capital mobility to be compatible.
- So far, the G7 has not managed to persuade governments to co-ordinate national interest-rate policies. It could do virtually nothing, for instance, about the unilateral decisions taken in the United States and Germany. The quality of G7 co-operation needs to be raised considerably and interest-rate policy covered.

b) A single Europe and financial stability

European business and industry sets great store by the achievement of economic and monetary union (EMU) as a means of limiting exposure to financial risk, at least in part for good reason. Not only would interest rates converge, the cost of bank intermediation fall and access to more competitive and diversified funding sources be facilitated, but the transition to stages 2 and 3 of the EMU would also gradually do away with exchange-rate risks within Europe and substantially lower transaction costs (especially were the scenario one of a single European currency replacing national currencies). But undue hopes should not be placed on a single Europe. Though EMU would bring about a much closer convergence of nominal and real interest rates, it would not in itself diminish interest-rate volatility in Europe, which reflects not only the impact of purely European factors but also interest-rate movements in the United States, Japan and elsewhere. It would do nothing to solve the problem of exchange rate fluctuations within the G3 (United States, Europe and Japan).

Two other aspects of European integration should be borne em in mind too:

- While the single market will have the effect of diminishing companies' commercial risks, a single European currency would limit monetary risk;
- The Ecu could, in certain conditions, act as a buffer against financial market instability. It came to be used by companies in their private dealings over the period 1980-1986, mainly for their financial transactions and to hedge all or part of their exchange-rate or interest-rate risks (the Ecu being defined in terms of a basket of currencies, its effective interest rate cannot diverge from its theoretical rate, which is equal to the weighted average interest rates of its component currencies). Since 1990, a fresh boost has been given to private use of the Ecu in financial transactions (its role in business transactions is still minimal), not because of increased interest-rate or exchange-rate volatility but because of growing belief in a Single Europe. Proposals to "strengthen" the Ecu could, if carried through, make the idea of a European currency more attractive to the business sector, in that it would become the prime instrument for managing and hedging risks.

3.3 The outlook

Private agents and particularly enterprises (financial and non-financial) will certainly also have a role to play in tackling the mounting instability on financial markets. Companies must be vigilant in limiting their exposure to monetary and financial risks and ensure that speculation accounts for only a specified (low) proportion of their productive activity. But, as was pointed out in the discussions, systemic risks and managing financial market instability are properly the concern of the authorities.

The process of financial change in the OECD area (and elsewhere) is by no means over. And the short- and medium-term financial outlook is coloured by a number of trends.

1) Analysis of prospects for financial innovation in the late 1990s must make two distinctions: first, between process innovation (new payment technologies) and product innovation; and second, between countries that are leaders in the field of financial innovation (such as the United States and the United Kingdom) and the "runner-up" countries that make up the rest of the field.

Process	Product innovation	innovation
"Leader" countries	No standstill	"digestion"
"Runner-up" countries	No standstill	catch-up

- It may be reasonably supposed that new payments technologies will continue to be introduced in all countries, how fast or how slowly depending on their experience. Any "technological standstill" is highly unlikely. Views were more differentiated regarding product innovation. Here the "leader" countries are already at the "digestion" stage. New financial instruments will of course be introduced but will be more in the nature of "minor" innovations, only marginally altering some aspect of existing products. The "runner-up" countries will probably continue to catch-up. Germany, which was converted to financial innovation only in 1988, is of special importance and is likely to see -- {Europe oblige!} -- a rapid diversification of its "menu" of financial instruments.
 - France, which lies somewhere midway between the United States and Germany in the financial innovation stakes, appears to have achieved a satisfactory degree of financial diversification and now needs more market liquidity, greater security of transactions and stronger stockmarket solidarity mechanisms. The same applies to a great number of OECD countries.
- 2) In the absence of any unforeseeable major stockmarket crisis, the coming years are likely to see continued growth of the other elements of the process of change on the financial scene: globalisation, deregulation, disintermediation, and securitisation. Securitisation, for instance, will catch on in a major way in countries that have only just started off down that road and even in others which have not yet done so. Under the effect of worldwide and European financial liberalisation, competition and the need for external competitiveness will force countries to "trade up" and align their financial systems on the most sophisticated ones.
- x3) The OECD countries' banking systems will have to traverse some difficult years, since profit margins look set to remain low. In many developed countries, several factors play a part here: deregulation (with its implications for the average and marginal cost of bank resources); greater domestic risks and the higher reserves they entail; the risk of overcapacity (supply potentially or

effectively exceeding demand) in some market niches for financial or banking services. In such a context, the pace of restructuring in the banking sector can be expected to quicken; the hope is that prudential supervision will be middle-of-the-road, neither too strict (with too many ratios, given that it would be desirable for financing decision-making to be devolved; nor too lenient (allowing harmful laissez-faire).

- 4) The achievement of European integration would send out a strong signal to markets and economic agents far beyond Europe. We have not yet reached the point of no return in the transition to EMU and it is to be hoped that the two intergovernmental conferences in progress since December 1990, the one on political union, the other on EMU, will produce a firm timetable leading up to the final stage.
- 5) The authorities have a crucial role to play in managing and containing financial market instability. It is for them to reactivate international co-ordination constructively so that it encompasses both fiscal and interest-rate policies in the prospect of continuing high real interest rates. It is for them, too, to ensure that financial market instability remains one of the parameters of economic policy decisions, so as to avoid crises generating loss of confidence in the workings of markets and destroying solidarity.

ANNEX

List of Participants

Management Experts

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Russel•• Confederation of Australian Industry

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Guy•• Conseil national du patronat français

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SNIJDERS• Deputy Director•••••NETHERLANDS
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ANDUJAR•• Spanish Confederation of Employers'•• "
José•• Associations (CEOE)

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Paul•• First National Bank of Chicago

VEIT•• Director General••••• " "
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•• Chairman of the Meeting

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RAPPORTEUR

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Bertrand• Association pour l'Union Monétaire de l'Europe

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END-OF-TEXT