

Liquidity Creation and Risk in the International Monetary System *

1. If one accepts the commonplace notions of banking risk, namely those of illiquidity or default, then this is a subject on which the less a central banker says the better. It is a fact that, when dealing with domestic issues, central bankers prefer to avoid discussing publicly situations in which there might be a role for them as lenders of last resort. This is all the more so when international banking issues are debated, because this is an area where none of the lenders is apparently willing to see the buck stopping in his own hands.

I have thus decided to refer to a much broader definition of both risk and risk management, and let me explain briefly the reasons for my choice.

I think it is not unfair to say that there are many who regard management of risk more as a way of reducing the cost of some negative occurrence rather than as a way of preventing it from happening. Certainly, for the overwhelming majority of individual market operators this is probably the only way to handle a risk situation. But for policymakers and for large institutional investors and bankers the management of risk should be — and no doubt is — something intellectually more challenging than buying some forward cover or splitting a loan within a large bank syndicate.

The crux of the matter is to try to assess nothing less than what makes the world monetary and financial system function and evolve. As commercial, merchant, and central bankers, we operate within an extremely complex and sophisticated market system where changes and disturbances can be quickly transmitted and amplified, where private dealers and official policymakers are becoming increasingly interdependent and where uncertainty finds countless ways of feeding itself. The

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real risk of such a system is that of becoming inherently unstable, and of destabilizing a variety of its own essential components — be they the exchange rate regime, the banking network, or the pattern of trade flows.

The management of such an overall risk is of course something beyond the capability of any individual financial institution or even individual Government to handle, and I do not have any magic formula to offer. I will concentrate my remarks on how the present financial system works, singling out what seems to me its most crucial function, namely the provision of liquidity and its impact on the broad spectrum of international financial variables.

Liquidity and risk are in fact closely interrelated concepts. As Keynes and Hicks taught us, a meaningful definition of liquidity cannot be given without reference to risk itself.

2. Under the Bretton Woods system, the creation of international liquidity depended largely on additions to the world gold stock and on deficits in the balance of payments of the United States. An element of discipline for the reserve center should have stemmed from the requirement that dollar balances be convertible into gold. But, as Professor Triffin observed some twenty years ago, being ultimately anchored to gold, such a system was bound to either be unduly constrained by gold output, if the United States maintained a broad balance in their external accounts, or lead to a breakdown of convertibility. As it turned out, a sharp acceleration of domestic monetary expansion and the emergence of large current account deficits in the United States led to the suspension of dollar convertibility in August 1971 and to a generalized system of floating exchange rates in March 1973.

Until 1973 the bulk of exchange reserves was held by the central banks of the industrial countries whose demand for international reserves was not significantly influenced by portfolio considerations. Concern about the maintenance of acceptable conditions of stability in foreign exchange markets often led these central banks to accept sizeable increases in their dollar holdings during periods of weakness of the U.S. balance of payments, and to participate in various international arrangements designed to preserve the system. Moreover, the demand for reserves of the great majority of other countries was largely for transaction purposes and, as such, was predominantly a demand for dollars, this being the currency in which most international transactions were invoiced.

The periodic outbursts of instability in the late sixties and the eventual breakdown of convertibility in 1971 should not be seen as the consequence of portfolio diversification by official reserve holders, but rather as the result of an overrapid expansion in the supply of dollars, against a background of deteriorating fundamentals of the U.S. economy. Not surprisingly, therefore, the studies and discussions on the reform of the international monetary system of the early seventies were centered on how to isolate the creation of international liquidity from the U.S. balance of payments and to extend to this country the "asset settlement" rule, this being one of the original aims of the creation of the SDR.

Since 1973, there has been a major accumulation of reserves by oil-exporting countries for whom the investment motive has been an important determinant of reserve management. In fact, for these countries the ready alternative to accumulating financial claims on international markets is to reduce oil production to a level consistent with their spending capacity and development objectives, a level, however, which would be inconsistent with the oil requirements of the importing nations.

The emergence of large imbalances in international payments, the transition to a floating exchange rate regime, and the climate of uncertainty which followed the first oil shock also induced a higher demand for gross reserves for precautionary motives by countries that were sensitive to risk-return considerations in the management of their reserves.¹

The currency composition of official reserves has also changed significantly during the last ten years. The Deutsche mark and, to a lesser extent, the yen and the Swiss franc have assumed a reserve currency status, while that of sterling declined. These trend movements have been accompanied by sizeable oscillations in currency shares. At the end of 1980 however the share of U.S. dollar in total exchange reserves was broadly the same as ten years earlier.

In sum, it appears that the large increase in official reserve holdings and their changed distribution have enhanced the importance of "pure" portfolio motives in official reserve management. The Euromarkets have offered a broad and efficient channel for moving funds between

¹ During the past decade, with total foreign exchange reserves rising from \$ 46 billion at end-1970 to some \$ 325 billion at end-1980, those held outside industrial countries increased from \$ 16 billion to \$ 150 billion, and their share in the total from 35 to 52 per cent.

markets and currencies, and have increased the incentive to do so by reducing transaction and information costs to almost nothing. Moreover, assets denominated in various currencies are now held by reserve holders' for reasons of risk diversification in conditions of flexible exchange rates, and this has favored the progressive development of a multicurrency reserve system. Hence, the elasticity of international capital flows to interest rate differentials and to expected exchange rate movements, and the overall potential for instability have risen considerably, as is shown by the large swings of banks' external positions in major financial centers in response to actual or expected changes in market conditions.

3. The accumulation of foreign exchange reserves outside industrial countries has coincided with the progressive growth of international markets, which have been able to accommodate smoothly demands for balance of payments financing by deficit countries.

Indeed, a major novelty has been widespread recourse to liability financing of external imbalances, rather than to reserve asset settlement, with the result that the creation of international means of payment has become largely endogenous. In turn, easy credit conditions have encouraged deficit countries to postpone adjustment and have accommodated an acceleration of inflation worldwide.

It must be acknowledged, indeed, that as long as large external imbalances persist, the "degree of intermediation" of the system will rise, and credit and international liquidity will continue to expand at high rates. Within this framework, the rapid growth of intermediation by international markets can be readily accounted for on grounds of relative competitive advantage and differential regulation. Undoubtedly the generally higher levels of interest rates which have prevailed since the first oil shock have increased the cost of regulation — in particular, that associated with reserve requirements — and have thus enhanced the relative attractiveness of international channels of intermediation. On the whole, what appears to have been driving the system are the oil-generated payments imbalances, to which the international banking system is offering a sophisticated — but largely passive — vehicle.

4. These developments have resulted in an unprecedented expansion of foreign indebtedness and of private banks' exposure vis-à-vis oil-importing countries. It is obvious that the practice of creating liquidity to finance current external deficits increases the risk

and potential for instability, unless the resources thus made available are used over time to expand investment and exports and to reduce import dependence.

As things now stand a main cause for concern is the foreign debt accumulated by non-oil developing countries and by countries in Eastern Europe. In the period 1974-80, the current account deficit of non oil-LDCs alone averaged more than 4 per cent of aggregate GNP, of which approximately one half (some 200 billion dollars) was financed in private markets, at interest rates that tended to rise and recently to become positive in real terms. By the end of 1980 the outstanding foreign debt of these two groups of countries had risen to 450 billion dollars, and the annual debt service to some 100 billion dollars, or 25 per cent of exports. Moreover, the concentration of this debt in a relatively small number of countries increases the potential repercussions of a default on world financial markets.

The expansion of balance-of-payments related loans by banks seems so far to have had only a modest impact on risk concentration. However, in a number of cases prudent lending limits to individual customers have been approached, and generally capital assets ratios have declined. Market spreads have on average remained low and in some instances have not adequately reflected lending risks. More in general, banks may not have been sufficiently cautious in their lending policies, perhaps operating under an unwarranted assumption that in case of difficulty they would be bailed out.

Altogether, the conclusion cannot be escaped that these various developments and practices have made the system more fragile and have diminished its ability to absorb new shocks. For a time rapid expansion of international credit was made possible by ample slack in banks' lending and countries' borrowing capacity. Now, these margins have been substantially reduced, and it is difficult to envisage a similarly rapid growth of lending in the future without endangering world financial stability.

5. The system which I have outlined would thus seem to be characterized by looser external discipline on most deficit countries, and by potentially greater instability, owing to an overrapid expansion of liquidity — both official and private — in international markets.

In this environment, the importance being attached to current account developments in the short-run in assessing currencies' prospects has, at times, led to an erosion of confidence and to exchange rate

movements not warranted by fundamentals. Thus, paradoxically, external discipline may have been strengthened on countries whose currency is playing a reserve role, as evidenced by the recent German experience.

The experience with fluctuating rates has shown that the exchange rate movements required to accommodate the oil-generated external imbalances might be unduly large, while the perverse short-term effects of exchange rate adjustment on international payments flows seem to have fed destabilizing expectations. The fact that exchange rate movements may be magnified by "sympathetic" shifts in public and private portfolios contributes to excessive modifications of relative price incentives and to a generalized increase of uncertainty.

6. The conclusions that can be drawn from the above considerations help to shed light on the policy actions that may be required to mitigate the problems and difficulties associated with the current international monetary setting.

The changes that have taken place in international monetary arrangements have responded to the need of accommodating large external imbalances; in the process the system has shown itself to possess resiliency and flexibility. However, the rapid increase in international reserves held for portfolio motives and the transition to a multicurrency reserve system have increased the potential for international monetary instability.

The efficiency of international financial markets, the huge volume of funds channelled through them, and the higher interest rate elasticity of international capital flows have reduced the viable differences between nominal interest rates in major financial centers and the scope for independent national policies. The conflict between domestic and external policy objectives is particularly serious at times when major economies show divergent inflation rates and unequal ability to adapt to the oil shocks. Also, the combination of large external imbalances and easy credit conditions may continue to encourage highly indebted countries to defer adjustment and in time endanger world financial stability.

In sum, it appears that we should not be complacent about the present system and the way it is evolving. We are confronted with complex and entirely new problems in a rapidly changing environment. The persistence of large external imbalances makes a return to a generalized asset settlement rule in international transactions a somewhat unrealistic goal. In these circumstances, policy action should be direc-

ted to tackling the sources of instability and tensions as they arise and are recognized, rather than seeking to implement comprehensive projects of reform.

It is evident that priority should continue to be assigned in all oil-importing countries — developed and developing alike — to the objectives of bringing down inflation and adjusting to the changed structure of relative prices. Greater convergence of inflation rates toward the low-end of the wide range which is now prevailing is an essential precondition for sustained growth as well for greater stability of exchange rates and international monetary relationships. Success in bringing down inflation and interest rates in industrial countries would represent a major contribution to reducing international risk and to maintaining conditions of stability in financial markets.

Stability in international markets may also require that, in their lending policies, private banks place greater emphasis on quality of credit and prudential control. The strengthening of supervision procedures and their application on a consolidated basis, following the indications of the G-10 Central Bank Governors, should assist banks in improving their assessment of lending risks and in maintaining the required degree of diversification of their portfolios.

Greater adjustment efforts by deficit countries and prudent lending behavior by banks can thus be singled out as the main requisites to bring international liquidity under better control. The increased role of the Bretton Woods institutions in financing external deficits — which has been made possible by the recent changes in their lending policies — will continue to serve both to encourage adjustment and to reduce the recycling burden of private markets.

Attention should be devoted to finding ways of reducing exchange rate instability. Indeed, the rapid development of international capital mobility and financial integration in the presence of divergent inflation rates and slow speed of adjustment in real goods markets, has led disturbances and disequilibria to be reflected in foreign exchange markets. In these circumstances, while official intervention should not be used to resist necessary exchange rate adjustment, an important role could be played by concerted action by major countries or currency areas to stabilize expectations and to offer an anchor whenever required to exchange markets that at times prove volatile.

In 1978, the announcement of a credible support package for the dollar was effective in breaking self-feeding speculative behavior in unsettled market conditions. The experience of the EMS also shows that

in the short run a reasonable degree of exchange stability can be attained. In general, it appears to be highly desirable for the major countries to pay greater attention to the international repercussions of domestic policies; a greater degree of coordination in this area seems feasible and should be sought.

Everything considered, the problems and issues examined in this paper clearly seem to suggest that this is not the time to propose grand designs of reform. Rather, what is required is a combination of sound domestic financial policies and international cooperation, with a view to reducing the causes of instability and the potential for a crisis. The international cooperation aspect should be given special emphasis at this juncture, when predominant reliance on monetary tools for domestic stabilization, at a time of widely divergent inflation rates, is placing considerable strain on foreign exchange and financial markets.

This apparently low-key approach stems from my belief that the evolution of international monetary relationships along the lines which have been emerging over the past few years cannot be stopped. However, in my view we can and must intervene to correct some of its shortcomings and to try to guide its evolution in an orderly manner.

Roma

LAMBERTO DINI