Financial markets: shock absorbers or shock creators?

Introductory speech by William R White
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Introduction

I am glad to have been invited by Charles to make a few welcoming observations about this important topic. The BIS and its various committees have been interested in questions pertaining to financial stability for many years.

More recently, these BIS committees have begun to focus much more on the interrelationships between the financial side and the real side of our economies. These feedbacks go in both directions. A weak real economy can feed back on the financial system, but a weak financial system can also feed back on the real side ("headwinds"). Accordingly, there is a potential here for both virtuous and vicious circles; what some might describe as "chaotic" outcomes. The one thing that is clear in such a highly interconnected world is that both risk measurement and macro forecasting are going to be enormously difficult. Whether as professional economists or policymakers, we should not delude ourselves into thinking that we know more about the future than we actually do.

The growing importance of markets

Under the influence of deregulation and technical progress, the global financial system has become much bigger, faster and freer than at any period in the post World War II era. Moreover, these markets have also become more opaque and complicated than a few decades ago. One central development is that financial intermediaries everywhere, but especially in the English-speaking countries, have lost ground to capital markets. Is this a good or bad thing? Are financial markets shock absorbers or shock creators? Without wishing to prejudge the discussions later today, I think the answer is "both", just as we now generally recognise that the old question of rules versus discretion is better phrased as how best to combine rules and discretion. A market-based world is safer in many respects than a bank-based world, not least because market disruptions do not threaten the payment system in the same way as bank failures.[1] Nevertheless, there may still be new concerns associated with a greater reliance on markets that should (and I hope are) receiving attention. We need better trade-offs between efficiency and stability. Let me illustrate this briefly using recent experience.

Markets as shock absorbers?

Consider this last year and the number and variety of shocks to which the global economy and the financial system were subjected: stock market collapses; the failure of reforms in Japan; 11 September; the war against terror; the failure of Enron; the breakdown of the Argentine currency board and banking system; and the Middle East conflict accompanied by sharply higher oil prices. Moreover, all this came on top of a global economic downturn that could easily have gathered momentum. Indeed, many were worried, after a long period of asset price increases and credit expansion accompanied by heavy fixed investment, that we might well have a “bust” to follow the earlier “boom” of the late 1990s.

In the face of these concerns, two facts stand out. First, the macroeconomic numbers to date (essentially through 2002 Q1) do not look so bad. A global economic recovery seems underway. Second, the financial system coped marvellously well. Credit continues to flow; albeit more expensively to the less creditworthy, but that is no bad thing. Payment systems operated more or less normally, even after 11 September. And finally, there has been little contagion to other countries from either the Argentine or Turkish crises. Whether this good news will continue, of course, remains to be seen.

This latter outcome raises the question of how the financial system was able to cope so successfully. Among the possible reasons, the easing of monetary and fiscal policies in many countries was clearly of crucial importance. However, I think a further answer can be found in the changing structure of

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[1] Harold James recently told me that the crisis of the 1930s was the only one where banks played the predominant role in the financial system. This means the current world is more like that prevailing prior to World War I. It is also interesting (see the 72nd BIS Annual Report, Chapter IV) that the 1930s was the only major case of price deflation after the 1850s to have been accompanied by declining levels of output.

financial markets themselves. They seem to have become both more complete and more resilient. Let me give a few examples.

Markets today are more “complete” in that they offer borrowers a growing diversity of channels through which credit can be extended. Thus, in 2001, as in 1998 when the CP market also dried up, many borrowers last year fell into their banks to get finance when market conditions worsened. Moreover, the bond markets stayed open and did record volumes of fund-raising for all but the least creditworthy of borrowers. The greater diversity of corporate credit was matched by new sources of funds for households as well. Mortgage refinancing in a number of countries accelerated enormously in 2000 and 2001 (aided by GSEs in the United States), which allowed households to reprofile their lifetime consumption as they wished. As consumers spent the “cash-out” from mortgage refinancing of properties which had increased in value, they contributed materially to keeping the recovery going. Markets are also more complete in that new instruments have emerged to allow the easier transfer of risks of various sorts to those deemed best able to manage it. Credit derivatives and Special Purpose Vehicles are two good examples of the genre, and both proved legally robust in the course of the financial stresses of last year.

A case can also be made that the markets have become more “resilient” in the face of stress. One important consideration is that, with lending being less **concentrated** in the banking system, losses are more widely dispersed. The proverbial Belgian dentists, venture capitalists, pension funds and insurance companies have all taken a hit. Accordingly, payment systems are now less at risk than in the past. Moreover, many financial institutions are now **measuring risk** much more carefully. A new credit culture has clearly sprung up, prompted in part by the work of the Basel Committee on Core Principles and the New Capital Accord. **Interrelated** markets also share shocks, making them easier to absorb overall. Finally, **information** about value is now easier and cheaper both to get and to exchange. This presumably reduces counterparty risk and helps keep markets functioning even when times are stressful.

Markets as shock creators?

Listing all of these positive attributes of modern financial markets could make me sound a bit naive; in fact, there is a countervailing downside to everything I have just said.

The fact that there are more channels for providing credit may also imply that credit will become more easily available. The danger of greater access, in turn, is that firms will use it and become excessively indebted. The same is also true of households. Excessive leverage means greater exposure to such shocks as rising interest rates. Moreover, as the Merton/Draghi/Giavazzi paper reminds us, this exposure could easily fall back on governments in unexpected ways. Even sovereigns can get drawn into this debt trap. In retrospect, the hearty welcome given to Argentina until last year by global bond markets was most unfortunate.

As for the “completeness” brought by new instruments, many still have to be tested in a more severe turndown than the one we have experienced thus far. Moreover, and credit derivatives are a good example of some potential problems, concerns remain that originators may have underpriced them due either to inexperience or in the context of efforts to exploit regulatory arbitrage. Finally, risk transfer capacities could lead to less “due diligence” on the part of originators, leading to more risky borrowers getting both more and cheaper credit than they would in an ideal world.

As for markets being more resilient, with risk being more widely spread, it is true that banks overall have become relatively less important and threats to the payment system less severe. Nevertheless, the growing degree of **concentration** both within the banking system and within individual markets could still be a cause for concern. Highly concentrated markets include the swaps market and the market for CB back-up facilities; about half of the latter is provided by JP Morgan-Chase alone. Moreover, a small number of banks now dominate the OTC derivatives market. Given these developments, it is not encouraging that the dominant financial institutions have also deteriorated significantly in credit quality. Physical concentration is also very high, with over half of all OTC and FX deals being done in London and New York. As is now well known in light of the events of 11 September, the clearing facilities in US fixed income and repos are also highly concentrated.

Risk measurement has also improved a great deal but there continue to be major shortcomings: macro shocks which simultaneously affect many companies and even whole industrial sectors need more attention; the common assumption that there is no correlation between the Probability of Default and Loss Given Default is palpably wrong; both internal and external credit ratings tend to move procyclically, as it seems to be human nature to assume that the good times will simply keep on rolling.

Interrelated markets may not diffuse shocks so much as to allow other markets to be affected in ways that would not previously have been the case. The instantaneous availability of the same cheap **information** by a wide range of investors may actually contribute to herding. And, in any event, how do we know that the information which drives markets is reliable? The Enron affair raised questions about conflicts of interest at every level of governance, which ultimately resulted in a very biased view of Enron's revenues, expenses and debt levels. And, more recently, similar problems pertaining to accurate accounting and information have been identified at a whole host of companies.

This, of course, raises an even broader question about governance. Why did no-one ask the right questions about appropriate supra-normal profits? If the simple answer is "because the going was good", that also tells us something about how information is processed in financial markets. Such behaviour leaves the way open for systematic overvaluation of asset prices (equities, houses, the US dollar) that could well burst, potentially creating shocks for the real economy in turn.

Conclusion

A well-functioning financial system requires well-functioning financial markets. The task currently seems to be how to identify polices that will tilt the balance to markets becoming shock absorbers rather than shock creators. However, should the financial system henceforward show more fragility than it has to date, attention might subsequently be focused on the proper balance between relying on financial intermediaries and on non-intermediated markets.