

Remarks by Cathy E. Minehan
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I want to thank Ira Stepanian for inviting me to speak on the occasion of the opening of Bank of Boston's new trading room. January 1995 is a particularly auspicious time for this event because of rapidly expanding opportunities for banks and their customers in international markets. These opportunities, however, coexist with a number of significant challenges. So much so, that when I was considering how to frame my remarks on Global Financial Trends, I was drawn to the Subtitle--1995: the good, the difficult and the downright ugly.

First, the good. Economic recovery has spread to all the major industrialized countries and is becoming increasingly well established even in Japan. The OECD (The Organization for Economic Cooperation and Development) characterizes prospects for its members as better than they have been for several years, with unemployment declining in most countries and inflation low and likely to remain so over the near term. Growth also continues

robust in many Asian and some Latin American countries and has resumed in some of the transitional economies of Central Europe and the Baltic--though not in Russia and other members of the old Soviet Union. The outlook has even begun to improve for individual countries in Africa, as a result of rising commodity prices and reform efforts. In total, the IMF expects real world output to grow at a 3.6 percent pace in 1995, a faster rate than any in the 90's.

This boom in world economic growth is coinciding with what will likely be the fifth year of economic recovery in the United States. Reflecting this, the IMF projects overall growth in world trade at 6 percent for 1995--a rate slightly behind the pace of 1994 but well ahead of earlier years in the decade. Indeed, U.S. export growth has been a major unexpected surprise in our domestic economy this year, and some analysts expect exports to be even stronger next year. This will be a major source of buoyancy for the U.S. economy, which, in turn, will have spillover

effects on countries that are major suppliers for goods that we export.

There is no doubt in my mind that NAFTA, and, more importantly, the successful conclusion of the Uruguay Round reinforces these favorable prospects. The GATT Agreement will greatly enhance trading opportunities for all countries over the long term and should bolster confidence and investment incentives even now. Conservative estimates indicate that over time the GATT agreement should bolster world trade by 10 percent and raise world income by \$250 billion or 1 percent, as a result of efficiency gains.

Of particular interest to banks, of course, is the fact that the new Agreement extends international rules like nondiscriminatory most-favored-nation provisions to trade in services for the first time. Unfortunately, progress in obtaining firm commitments and setting a schedule for opening up the financial services sector in countries like Japan, Korea, Brazil and Indonesia was not satisfactory to several countries--particularly to the United States.

Negotiations are scheduled to continue for the next six months. By contrast, NAFTA provisions on financial services, which will presumably be extended to other Latin American countries joining the pact, are much more satisfactory. For example, even before the concessions related to the recent financial crisis, full access to Mexican financial markets were to be phased in over a period of five years.

More generally, the trend toward freer trade is being mirrored in world-wide trends toward deregulation, privatization and the opening of markets to competition. Developed and developing countries alike understand the benefits of liberalizing their financial markets and are beginning to do so. Over the last several years, such liberalization has led to substantial capital inflows to developing countries and contributed to robust growth and investment. However, it is this very success and the demand for further investment that prompts me to reflect on the possible difficult aspects of 1995.

In the midst of a world-wide cyclical upturn, the key areas of difficulty are likely to be structural in nature--that is adjusting to the ongoing processes set in place by the trend toward freer, more open markets everywhere. The first of these relates to what is likely to be an extraordinary degree of competition for available investment capital. Competitive pressures will keep long term interest rates high and investment dollars rationed to the most promising projects. Even in countries such as those in Southeast Asia where internal savings rates are multiples of our own, there is expected to be a substantial gap between savings available locally and needed infrastructure investment. I spoke at a Conference in Singapore in early December devoted entirely to financing growth and infrastructure development in Asia. Conservative estimates made at that Conference suggested that better than \$1.5 trillion will be needed over the next decade or so in that part of the world alone. I don't have the figures for Eastern Europe, Russia or China but the total has to be staggering.

Beyond the sheer competition for funds, open markets and the sophistication of world-wide banking and financial market participants create difficult challenges for national economic management. Countries must become more productive and competitive to retain national savings, let alone attract outside investment. And, as we have seen in Mexico, the ability to attract investment is no guarantee that it will remain. What is needed are credible economic policies that avoid the temptation of excessive money growth, overvalued currencies, and deteriorating current account positions. And, I would argue, this applies not just to developing or transitional countries but also to the industrialized world as well.

The need for disciplined monetary management seems widely recognized. It may come as a surprise to some of you, but the Federal Reserve is neither the only central bank focused on halting inflationary growth before it begins, nor the most aggressive in doing so. Countries such as Canada, Australia, and New Zealand have enacted inflation targets and have assigned the central bank

the sole function of holding down already low inflation, in some cases without regard to the impact on economic growth. We met recently with the Deputy Governor of the Bank of Canada who noted they were in the process of reducing their inflation target range even in the face of unemployment of 10-11 percent. I think we might have some political difficulty with that trade-off in this country. Beyond those countries with inflation targets, there is a broader group where the issue is increasing central bank independence--again for the sake of enhancing monetary restraint. Worldwide there is a recognition that inflation undermines market confidence and in this new world of competition, confidence factors are paramount.

Increased monetary discipline should be accompanied by fiscal discipline. To be sure, long term interest rates would be under less upward pressure if the industrialized countries, not just countries like China and Russia, pursued more conservative fiscal policies. According to the OECD again, structural government deficits in the seven largest industrialized countries except Japan

are expected to exceed 3 percent of potential GDP in 1995, and even Japan has a projected deficit. Thus, I would expect deficit cutting will be an issue not only in the United States but also in many other countries as we move into 1995 and beyond.

This takes me to the downright ugly. That's the only way to characterize the all too human tendency to adopt a herd or pack mentality. This tendency of market participants to take large, one-sided bets on the evolution of market developments, and then to change that view abruptly, contributed to the LCD debt crisis of the early 1980's, the New England real estate crisis of the late 80's, this year's bond market turmoil, the dollar's sharp decline this fall, and most recently the crisis of confidence affecting Mexico and threatening to spill over into other Latin American markets. It is tempting to say that this herd mentality is the product of ever increasing technology and sophisticated financial markets and instruments that allow for the speedy transmission of problems from one market to another, and one country to another. To some degree that's true. But I should also note that a small,

readable book by Charles Kindleberger called Manias, Panics and Crashes documents such herd behavior back hundreds of years.

We aren't speculating in tulip bulbs or South Sea Islands anymore but the effect of the herd mentality is the same--debilitating market and financial instability.

Mark-to-market accounting methods, explicit loss limits and other measures have been quite successful in limiting the consequences of this year's bond and exchange market disruptions for the industrialized countries. However, regulatory and supervisory authorities still face the challenge of ensuring that investors can bear potential losses without those losses spilling over onto innocent bystanders through breakdowns in payment and settlement systems or in weakened macroeconomic performance. Steps to price market risk, improved disclosure standards, and efforts to implement large position and information systems for banks and nonbanks would also be helpful. Ultimately, however, in increasingly open and deregulated economies, the responsibility for avoiding periodic crises must rest

not only with central banks as they oversee the regulatory structure, but also with individual financial institutions themselves. At the end of the day, there can be no substitute for the rigorous control mechanisms and mature lending policies that can only be provided by prudent financial institutions.

In closing, the international prospects for 1995 are bright. We are in the midst of a world-wide cyclical upturn, and meaningful structural change in the openness and competitiveness of markets provides many opportunities for financial returns. Important challenges exist both in meeting the world's burgeoning demands for capital and in the risks associated with doing so. But I think both we in the Federal Reserve, and the major U.S. financial institutions like the Bank of Boston are well positioned to deal with these challenges.

Thank you.