Financial Globalisation

Opening remarks by Mr William R White, Economic Adviser and Head of Monetary and Economic Department of the BIS, at the BIS Fifth Annual Research Conference on "Financial Globalisation", Brunnen, 19 June 2006.

Abstract

Global financial integration has a number of implications and can pose complications for policymakers. As to implications, consider the rising correlation among global asset prices, the greater ease with which current account deficits can now be financed and the wealth effects on creditors holding huge amounts of US dollar denominated assets should the dollar fall. As to complications for policy makers, both monetary tightening and easing is different when the effects of exchange rate changes do much of the work. As well, supervisors face formidable home-host issues as do providers of Emerging Lending Assistance. Finally, the absence of burden sharing agreements in a globalised world could impede the process of crisis management.

Full speech

May I begin by welcoming you all to Brunnen. As happened two years ago, the fact that the Basel Art Fair coincided with our planned conference meant that there was effectively no hotel accommodation to be found in the city. Accordingly, we all find ourselves in this beautiful place, albeit somewhat harder to reach than Basel. May I also say, representing the central bankers assembled here, that I am particularly pleased to welcome our many friends from universities and think tanks around the world. As on previous occasions, we central bankers will gain a great deal from your analysis of the problems that we face. And, by the same token, I hope that that you will have a clearer idea after this conference what central bankers think the problems are. And putting the two together, I also hope that you might be inspired to think about these problems still further after the conference ends.

Policymaking has always been a difficult business, but recent structural changes in the global economy have made things more difficult still. In light of these changes, the pessimists would contend that the fundamental analytical framework we use needs to be seriously reconsidered; in particular, I believe the post War Keynesian consensus needs to be confronted with pre-War business cycle theory. Others are more optimistic about the continuing relevance of their model, but even they are still troubled by significant parameter shifts and large forecasting errors. Everywhere, one senses a growing modesty in our assessment of what we really know. The underlying issue is what Hayek in his 1974 Nobel Lecture called "The pretence of knowledge", and what Larry Summers has referred to more recently as "The scientific illusion in empirical macroeconomics".

The structural changes I refer to are three in nature; one real, one monetary and one financial, the last being the topic of this conference. The first change has profoundly affected the real global economy. Liberalisation of product and factor markets, allied with technological developments, has increased output in many countries and particularly so in the previously centrally planned economies. I believe that these developments have aided central bankers everywhere in their attempts to reduce inflation and to keep it low. The second major change has in fact been the growing, global commitment to this objective after the Great Inflation of the 1970s. The third major structural change, again reflecting both deregulation and technology, has been the growing completeness and integration of world financial markets. While the efficiency gains associated with such developments are not in question, it could also be contended that they pose a particular challenge to central bankers, and not only during the transition period to a more liberalised regime.

I will not spend much time "proving" that financial markets today have become highly globalised in character, and thus more complete. While the size of international capital flows (relative to output) was likely higher prior to World War 1, the short term nature of many of today's flows, the high turnover in financial markets, the multiplicity of agents, the number and complexity of instruments, and the speed with which market participants can react to new information is surely unprecedented. Moreover, the global reach of financial institutions, particularly banks, also needs to be noted. In large parts of Latin America, Central and Eastern Europe and Africa, foreign banks constitute the largest part of the banking system. Moreover, they are both borrowing and lending in local currency and are being increasingly integrated into the local economy.

These cross border developments have had a number of implications. Let me briefly consider a few of these, before turning to how they can significantly complicate the lives of policy makers.

Perhaps the first implication to note has been the growing integration of financial markets, including those in emerging market countries, with subsequent impacts on the covariance (perhaps even "excessive covariance") of asset prices. Over the last year or two, equity prices in virtually every emerging market economy (EME) have risen strongly while sovereign spreads dipped to record lows. Even more astonishing, the sharp increase in house prices in most industrial countries has also been reflected by similar sharp increases in many EMEs. While arguments can be put forward to explain these developments in terms of "pull" factors (better policies) in EMEs, there seems a reasonable chance that "push" factors are also in play. The sharp increase in competition in the financial services industry in the industrial world, together with high hurdle rates and very low policy rates, have fostered a search for yield that has affected markets everywhere.

A second implication is that current account deficits have become easier to finance than before. We saw this in Mexico in the early 1990s, East Asia a few years later, and in central and Eastern Europe more recently. The ease with which the United States has managed to attract funds to support its current account deficit, and large capital investments abroad, is also remarkable. This said, the growing proportion of inflows in the form of shorter term and inherently safer instruments (Treasuries and agencies) and the growing role of official purchases (especially by Asian central banks) may both indicate a private sector appetite for dollar denominated assets that is finally beginning to wane.

A final implication has to do with currency mismatch effects. We are all aware of the devastating effects that currency mismatches had in the Mexican crisis of 1994, the Asian crisis of 1997, and the Argentine crisis of 2001. In those cases, borrowers had borrowed in foreign currency and devaluation punished the debtors. Today, we have a similar phenomenon in that the US has borrowed heavily abroad, but almost entirely using dollar denominated liabilities. This implies that, just at the time creditor countries could be facing the challenge of appreciating currencies and more competitive trade markets, they would also be facing the "headwinds" of sharp wealth losses on dollar denominated assets. This will hinder, not help, the process of global current account adjustment.

In what way does the international dimension complicate the lives of central bankers. Consider first, the conduct of monetary policy in tightening mode, with price stability as the ultimate objective of policy. As interest rates begin to rise, the currency will tend to strengthen. This will have a downward influence on inflation, implying that interest rates have to rise less than otherwise. This can have two dangerous effects. First, if the combined effect on the price of tradables is greater than on non tradables, the trade account may deteriorate. Second, with domestic interest rates relatively low, asset prices could rise and even take on "bubble" like dimensions. With spending further supported by this phenomenon, there would likely be further deleterious affects on the trade account. In the end, the markets could lose patience and a crisis might follow.

This sounds very much like the dynamics of the Mexican and South East Asian crises, and the more recent experiences of Iceland, Hungary, New Zealand and a number of others. Indeed, the external and internal imbalances faced by the New Zealand authorities, the pioneers of inflation targeting, have recently led them to undertake a complete review of their current monetary framework. And while it would be tempting to say that the international complication is really only material for small open economies, what has been going on in the English speaking countries, in particular the United States, also seems qualitatively similar. The rate at which the US is becoming externally indebted is, in itself, a cause for concern. Moreover, such concerns must be heightened by the recognition that the money lent by foreigners has been spent on bigger houses and higher oil prices, rather than investment in the tradable goods sector. The US deficit also has the potential to unleash a bout of global protectionism, which is not the case when small economies run into similar problems.

Easing monetary policy in a financially integrated world also has complications. One possibility is that the exchange rate will again do the lion's share of the work. The danger here is that an orderly decline will turn into a disorderly one, necessitating a sharp increase in policy rates to stabilise the situation. We saw this on a number of occasions in Canada in the 1980s, and we have had a more recent example in Turkey. The end result of such policies could be, tightening, rather than the intended easing. It is not a pleasant experience to find yourself going in the opposite direction from that originally intended.

In contrast, the exchange rate might not move enough to stimulate the economy, via the trade side, perhaps because the counties that would have an appreciating exchange rate in consequence, refuse to allow it to happen. This was the situation which presented itself to the United States between 2001 and 2004, as China and (to a lesser degree) other Asian countries refused to allow their currencies to appreciate. The upshot of this situation was that the US had to rely disproportionately on lower policy rates to do the stimulative work, while China and other countries turned to easier (or at least not tighter) monetary policy to resist currency appreciation. The result was a world awash in liquidity, saved from inflation only by the massive increase in global supply potential arising from the re entry into the global economy of countries like India and China.

But the globalisation of the financial system poses other policy complications as well. For those of us who work at the BIS, questions having to do with financial stability are only slightly less important than those having to do with monetary or price stability. Banking supervision in a globalised world poses huge challenges for the relationship between home and host supervisors as they collectively seek to prevent crises from happening. The oversight of international payment and settlement systems is another important cross-border issue. And in a financial crisis where Emergency Liquidity Assistance is required, who is to give it? Home? Host? And in what currency, given the multilateral commitments of the financial firm likely to be in trouble? There are a lot of issues to think about here, particularly since the absence of clarity about the limited role of the public sector positively encourages moral hazard. It is already possible that many firms already consider themselves either too big or too complex to fail.

Should the global financial system be subject to a sharp shock somewhere, the issue of how large, complex financial institutions might be wound down remains unresolved. There are continuing concerns about the limitations of information sharing among the various countries affected. Moreover, the question of who might bear the costs still remains undecided. At the worst, this leaves open the possibility of the failure of a global bank that is "too big to save" for a relatively small home country. At the best, this opens the possibility of "gaming" in the midst of a global problem as officials try to act in their own national interest. And, in addition, there is the problem of relatively small countries whose banking and financial systems are dominated by financial firms from other countries. How are they to continue operating efficiently when such dominant firms fail?

To finish my comments, this is all by way of a typically, rather dark, BIS welcome to those who have joined us here in Brunnen. The globalisation of financial markets provides both enormous opportunities and enormous challenges. I hope that in the course of the next day and a half, we will show some evidence of having responded to the challenges in particular. In anticipation of this outcome, let me thank all of you who have come long distances to be here, especially our academic friends. And finally let me thank my economist colleagues at the BIS, Claudio Borio, Gabriele Galati and Andy Filardo, and also Janet Plancherel for all the logistics. Everyone has put in great efforts to make this event happen. My thanks to all.