Implications of globalisation for financial stability

On 4 November 2005, the Banque de France held its biennial symposium, devoted to the topic of "Productivity, competitiveness and globalisation". Some 20 speakers from central banks, international organisations, universities and the private sector contributed to the discussions, with the presence and participation of around 200 representatives of these different spheres of activity.

The symposium was comprised of three sessions, followed by a round table. The former considered recent trends in productivity and competitiveness, their impact on international capital allocation, and economic policy responses and their resulting spontaneous adjustments.

The roundtable, chaired by Roger Ferguson, Vice Chairman of the Board of Governors of the US Federal Reserve System and Chairman of the Financial Stability Forum until April 2006, brought the symposium to a close on a more financial note. The prevention and management of financial crises in both emerging and industrialised countries were discussed by the following five panellists: Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, David Dodge, Governor of the Bank of Canada, Jacob A. Frenkel, Chairman of the Group of Thirty, Toshihiko Fukui, Governor of the Bank of Japan and Yaga Venugopal Reddy, Governor of the Reserve Bank of India.

Particular focus was placed on the optimum level of regulation required in order to benefit from the significant increase in capital flows while limiting the repercussions of overly sharp reactions by the markets. Also discussed was the need for an all-encompassing approach to adjusting global imbalances, combining all the levers: global demand, prices, and exchange rates.

The papers presented during the round table and the three preceding sessions are available on-line at www.banque-france.fr *(Publications and Research, Proceedings of Seminars and Symposiums).*

To give an insight into the views expressed during the roundtable discussions, Roger Ferguson's introduction and Jacob A. Frenkel's concluding remarks are being published in this issue of the Banque de France's Financial Stability Review. Roger Ferguson highlights four factors that contribute to exacerbating financial risks relating to globalisation: the emergence of major financial crises in emerging-market economies; a more complex institutional backdrop, as illustrated by the growth in hedge funds; the uncertainties surrounding some of the risk bearers of last resort, i.e. *reinsurers and households; and the appearance of new financial products, whose impact in times of crisis is still unknown. Jacob A. Frenkel points out the increasing emphasis placed on financial stability issues and debates the risks of over-regulating, calling for a reopening of discussions on capital account convertibility.*

1| SPEECH BY ROGER FERGUSON

Let me introduce the next panel by using an outline from my old days in the private sector. At McKinsey, we used to organise the discussions around the following topics: the situation, the complication, and then the solution.

As for the situation, a "Paris Consensus" seems to have emerged. We all recognise that the global imbalances are unsustainable in the literal sense of the word and that they will not go on forever. There is no final agreement on the causes of these imbalances, but a number of candidates have emerged –such as productivity differentials across economies and relative growth rates– and I think that all of us can find some comfort in one of those explanations. Finally, part of the "Paris Consensus" is that the possibility of the global imbalances unwinding in an orderly way has not been discounted, but yet a concern that the unwinding might be disorderly, a so-called hard landing in the ways that we have all talked about, is clear among those in this room.

I would like to add a bit to the "Paris Consensus" and, at the same time, highlight some work done by colleagues at the Federal Reserve. In a recent paper entitled "Currency crashes and bond yields in industrial countries", Joseph Gagnon examined twenty-six incidents of currency crashes across the globe in the past twenty years. He found that, since 1985, these so-called currency crashes have actually not been terribly disruptive; they have not led to a dramatic increase in interest rates, for example, or to a dramatic deceleration of growth in industrial economies. Another paper by Federal Reserve economists is "Financial market developments and economic activity during current account adjustments in industrial economies". The authors, Hilary Croke, Steven B. Kamin, and Sylvain Leduc, found little evidence that shrinking current account deficits, at least in industrial countries, are accompanied by sharply weaker currencies and recessions. Hence, some reasons for cautious optimism can be found in such work by Fed staff members.

So that is the situation, the "Paris Consensus", as I see it. The complication is in the topic that we want to discuss now. As Christian Noyer said at the opening, these conversations need to consider the question of financial stability. The first complicating factor is that during this recent period of great productivity and globalisation, we have seen financial instability crises, such as occurred in 1997 and 1998, arising from the emerging-market economies. Those crises indicated that rapid movements of capital, which have been helpful to the United States, could be detrimental to economies with weak policy or institutional frameworks. The instabilities emanating from the emerging markets in turn created the risk of a negative impact on the United States. We have also seen the more surprising story of Japan, to which I think Otmar Issing alluded, which illustrates the possibility of instability arising in an industrial economy.

The second complication in this world of globalisation and high productivity is that the institutional backdrop has become more complex over the past twenty years. One example is the hedge fund industry, which was earlier alluded to with the mention of LTCM –Long-Term Capital Management–. We now have a hedge fund industry that is about one trillion dollars in size. To some people, this industry is relatively opaque; others have greater confidence in it but still find it to be large. According to hedge fund industry data, about 8,500 funds exist right now. The average size of a hedge fund is about USD 120 million, which is the size of a small to medium-sized bank in the United States. Therefore, no single hedge fund is likely to be systemically important. But even a fragmented industry has risks of "herding" behaviours and of high correlations across members' strategies. Also, even though the average hedge fund is not large, the concentration of assets in the industry is another complexity. Clearly, institutional changes are an issue.

A third complexity is that the risk bearers of last resort fall into two categories. The first ones are institutional, in the form of insurers or re-insurers. The re-insurers, like hedge funds, may be a bit opaque to some in the public sector. The number of re-insurers is small, and the institutions are well-regulated, but the composition of their balance sheets and their risk exposures are, for many observers, not clear. The other shock absorber of last resort is the household sector. There is some concern, expressed by some people in this room, about the leverage that exists on households' balance sheets and the degree to which households are relying on accommodative interest rates.

The fourth complexity, as we consider these global imbalances and their possible unwinding, is that a number of new products have emerged over the past twenty years. The credit default swap market has become significant as a way to transfer risk to the balance sheets of those who think they can best bear that risk. This development must be considered to be positive. However, some observers have expressed concern that many of these new products have not been tested during severe stress. The credit default market was tested in the United States when General Motors and Ford were downgraded. The market worked well, but as a test the downgrade was limited. More-exotic products have also emerged during the past few years –for example, interest-only mortgages, negative amortisation mortgages, and option adjustable rate mortgages. These products have not been tested under the kind of rapid changes in macroeconomic circumstances and of interest rates that could follow from a rapid adjustment of the imbalances.

These considerations all lead to this important and distinguished panel. I would put before them just three questions. First, in general, can the current policies, or others that we can reasonably implement, increase both macroeconomic and financial stability? Second, as a result of institutional and policy changes since the late 1990's, are the emerging economies better positioned than they were to withstand whatever changes may occur as part of the inevitable adjustment of these various imbalances? My third question has two parts: Have the risk-management skills of these newer institutions and their counterparties evolved sufficiently, and are the institutions prepared to deal with the adjustments that are likely to be a part of the unwinding of various imbalances we have discussed?

We have an excellent panel to look at the issues discussed today and perhaps answer these questions. From the industrial economies we have Governor Dodge from the Bank of Canada and Governor Fukui from the Bank of Japan. From the emerging economies, we have two distinguished policymakers as well: Y.V. Reddy from the Reserve Bank of India and Zeti Akhtar Aziz from Bank Negara Malaysia. Finally, Jacob Frenkel in the recent past was a distinguished policymaker and is the current chair of the Group of Thirty, which brings together policymakers and individuals from the private sector. So I would hope that he can give us a little bit of both perspectives.

2| Speech by Jacob A. FRENKEL

The theme of this conference has been: "Global Imbalances, Financial Stability, and Productivity". Those issues are central to the understanding of the operation of the international economic and financial systems. They are extremely timely, at the present junction of the world economy. Occasional observation of the global economic scene over the past twenty years reveals that the very same issues have occupied policy makers throughout the period but yet the world has undergone fundamental changes during the past twenty years and, as a result, the implications of imbalances, financial stability, and productivity are different today than what they were in the past.

The interdependence among economies reflects the globalisation of the economic scene. Economic policies in one country have their impact on others. This has been the fundamental *raison d'être* underlying the concept of international policy coordination which has gained special prominence in the second part of the 1980's. In 1985, at the Plaza Accord, the entire focus of policy coordination was reflected in exchange rate adjustments. The value of the dollar was reduced through policy coordination. Shortly thereafter at the Louvre Accord in 1987, the coordination of economic policies was expended to include a broader range of macroeconomic policies in particular fiscal policies. The focus at that time was on budget deficits and external imbalances. The challenge was how to reduce the large surpluses of Japan and West Germany, which at the time were the "locomotives" of the world economy, while at the same time reduce the large deficits of the US. Of course, times have changed. West Germany has been unified with East Germany and has slowed down significantly while suffering from large budgetary burdens, and Japan has gone through the worst decade in its modern economic history, suffering from a prolonged recession and ever-expanding budget deficits and government debt.

The world economic system has changed dramatically. Capital markets have become much more integrated, and various economic crises have been intimately linked to the vulnerabilities of financial markets. LTCM, Enron, the Asian financial crisis, the Russian financial crisis, to mention a few, have all been manifestations of the new breed of the international financial system reflecting elements that were not as prominent even twenty years ago.

Not only has the nature of the markets changed, but also the main players in the global economic scene. Enough is to mention the growing role of Asia and in particular the rising prominence of China and India in the global scene. Against this background it is relevant to note that even though the range of issues addressed in this conference and, in particular, the challenge posed by the large global imbalances, are similar to the issues addressed twenty years ago but, that similarity is only apparent. The new nature of capital markets makes the challenge at the present juncture very different from the one in the past.

In order to appreciate the nature of the challenge, it is enough to recall that the US has been running a current account deficit of about 800 billion US dollars during 2005 which comprises about 6.5% of its GDP. That deficit has been growing steadily during the past few years and if it was not for the extraordinary appetite of a few central banks in Asia for the accumulation of foreign exchange reserves, the strains on the world capital markets induced by the large deficit would have been very severe. At the present time, China and Japan alone are holding about 1.7 trillion US dollars worth of international reserves; where China alone has accumulated over 400 billion US dollars just in the past two years. There is a growing consensus that such accumulation is unlikely to continue indefinitely; after all, trees do not grow to the sky. While the United States has been running a current account deficit in excess of about 800 billion US dollars during 2005, other economies have run significant surpluses. In this regard, Asia's surplus has exceeded 300 billion US dollars, whereas the surplus of the Middle East oil exporters plus that of Russia has also reached about 300 billion US dollars. This massive change of the distribution of wealth reflects a source of significant vulnerability.

While much of the focus in the public debate has been given to the large and growing imbalances in the current accounts of the balance of payments, the world economic system is challenged by many more imbalances including large budget deficits which reached in 2005 about 2.6 percent of GDP in the US and in the Eurozone and it reached about 6.5 percent of GDP in Japan. In addition, the large imbalances in the balance of trade and, in particular, the deteriorating trade balance of the United States threatens the emergence of extremely dangerous protectionist sentiments.

The most fundamental imbalance in the world economy relates to the saving propensities among the major countries. On the one extreme, the United States has a very low savings rate which is about 10 percent of GDP in 2005 while on the other extreme stands China with a very high savings rate reaching about 50 percent of its GDP. Between these two extremes stand India and Japan with national savings rates of about 25 percent, and the Eurozone with a savings rate of about 20 percent. Obviously, with such great diversity among national savings rates it is no wonder that the current accounts of the various countries reveal such a degree of imbalance.

In addition to these budgetary and current account imbalances, there are many other "imbalances" and disparities that characterize the world economic system. In this regard, it is enough to recall the imbalances in the energy field, in the pension system, in the degree of income inequality, in the different degrees of flexibility of national labor markets, in the demographic characteristics of various countries and regions in the world, in the social security system and the like. This wide range of imbalances implies that in order to address them there is a need to employ a broad array of policy instruments. These policies include macroeconomic as well as microeconomic policies. In particular, special attention should be given to strengthening the banking system, improving the functioning of financial markets including the market for foreign exchange, while accompanying these developments with the appropriate supervisory and regulatory mechanisms. In addition, policies must secure the openness of the various markets to free international trade in goods, services, and capital. Of course, this is a very tall order of economic policy challenges as it combines the broad array of macroeconomic and structural economic policies.

Unfortunately, policy makers have not exhibited a great appetite for dealing with structural measures. The lack of political will has reflected the notion that the political cost of dealing with structural issues is incurred up front whereas the benefits are widely spread in the distant future. The process of globalisation and, in particular, globalisation of capital markets, reduces significantly the force of this argument. In a well functioning capital market, current prices and rates of return reflect

the expectations of market participants about the future course of policies and events. Therefore, in a fundamental sense, one of the important roles of capital markets is to bring the future "closer" to the present. In a sense, under these circumstances, the "long run" is much closer to the "short run" than what it used to be. As it were, we are in a "fast forward" mode. Politicians, therefore, are now more likely to see the benefits of the structural measures during their own term in office and, as a result, some of the obstacles for the implementation of such policies are diminished. This is one of the important benefits of globalisation of capital markets and, thereby, also one of the main arguments for putting structural measures that enhance the flexibility of the economic systems high on the economic policy agenda.

The growing role that capital markets play in the modern economic system and the increased integration among national capital markets has shifted the policy attention toward securing financial stability. During the past few years, it has become clear that the traditional policy objective of securing price stability needs to be augmented by an additional policy objective: securing financial stability. After all, it is the weaknesses in the financial system that has been at the center of recent economic crises. As a result, much more attention is now given to the structure of the balance sheets of banks and financial institutions, to the role of transparency, as well as to the design of regulatory, supervisory and prudential systems.

There is a wise Chinese proverb stating that "the honey is sweet but the bee stings". The challenge is how to benefit from the sweetness of the honey without being stung. Globalisation and structural measures generate the sweet honey but are frequently accompanied by some short-term hardships. The challenge is to secure the great benefits from the openness of markets and from the flexibility of the economic system while minimizing the hardships that occasionally arise in the short run following the adoption of the structural measures.

While there is a growing consensus that the large and growing current account imbalances are not sustainable, there does not seem to be the requisite urgency to deal effectively with these imbalances. To be sure, by the very definition of being "non-sustainable", it is obvious that this process will come to a halt. The question, however, is will the adjustment be orderly and navigated properly by the appropriate policy measures, or will the markets lose patience with the lack of policy response and respond abruptly and generate great disruptions.

One of the reasons for the unsatisfactory policy response is that previous forecasts have not materialized and, thereby, have reduced the credibility of the economic analysis. For example, we were told that the large budget deficit in the United States will result in a higher long-term real rate of interest. In fact, the long-term rate of interest declined and stayed low (the famous Greenspan conundrum). We were told that the large and growing current account deficit of the United States will result in a depreciation of the value of the US dollar. In fact, the dollar has strengthened. We were told that a sustained rise in the price of oil will result in higher inflation as well as in a slowdown of economic growth. In fact, inflation has not accelerated, economic growth seems to be robust, and the unemployment rate is on the decline. We were told that when the Federal Reserve adopts a strategy of raising the short-term rate of interest in a systematic manner, eventually the long-term rate will follow suit. In fact, the Federal Reserve has raised interest rates fifteen consecutive times with very little response on the long-term rate and, thereby, resulting in a flat and even negatively sloped yield curve. These and similar phenomena have undercut some of the credibility of the conventional economic analysis, have raised the possibility of a paradigm change, and may have contributed to the relative sanguine attitude. It would be a risky policy gamble to assume that because the predicted consequences of deficits and policies have not yet materialized, the various imbalances can be sustainable much longer.

Waiting for economic and financial crises would be an expensive way to sort out the various puzzles. It would be the wrong way. The analysis of crisis is typically divided into two: crisis prevention and crisis resolution. There is a professional consensus that the prevention of a crisis is the less costly alternative. To be successful, the well known policy package must be in place. It includes a solid fiscal system with low budget deficit and non-distorting taxes, price stability, a solid banking and financial system, a well functioning capital market, a well functioning foreign exchange market, and the appropriate institutions and regulations that secure

the attainment of the above. If, however, a crisis does erupt it is extremely important that it is dealt with effectively and promptly. The appropriate management and resolution of the crisis entails a complex set of policies about which I will not elaborate in these remarks. However, one important principle needs to be highlighted: in resolving a crisis one needs to be extremely careful not to sow the seed for the next crisis. Consequently, one should be very careful to resist the temptation of engaging in a wholesale bailout operation without paying due attention to the short-term and long-term budgetary consequences of the bailout operations and without paying due attention to the "moral hazard" that results from such operations and that may distort future patterns of risk taking. Accordingly, the criteria for assessing the success or failure of a specific crisis resolution should not just be in terms of the success in "extinguishing the fire" but rather in the success in preventing the next fire. These considerations have profound indications to the choice of the optimal degree of regulation. A system that is over-regulated can be as bad as a system that is under-regulated.

The various crises that took place during the past decade have been costly, but I believe it is fair to say that the world financial system and, in particular, the banking and financial systems in emerging economies are now much stronger than what they used to be. International reserve holdings have been rebuilt (and in some cases maybe even excessively so), capital markets have been improved, supervisory and regulatory systems are more solid than what they used to be, foreign exchange markets are deeper and more resilient, and there is a widespread understanding that it is a mistake (and even futile) to engage in massive foreign exchange interventions with an aim to cling to the wrong exchange rate and prevent the manifestation of market forces. In fact, the adoption of flexible exchange rates has proven to be effective in reducing the likelihood of future crises. It has also contributed to the recognition that a successful functioning of the foreign exchange market requires building the appropriate infrastructure.

Let me conclude with one final thought. Before the onset of the Asian financial crisis in 1997, the IMF has almost completed the preparation for the adoption of a new amendment to its Articles of Agreement. This amendment was to require the membership to adopt (with some conditions) convertibility of capital account transactions in an analogous way in which members, under the current Articles of Agreement, are expected to adopt convertibility for transactions in the trade account. This proposed amendment reflected the belief that with a growing degree of globalisation and with the advances in capital markets, the world economic system would benefit from free movement of capital which, in turn, necessitates convertibility of capital account transactions. The eruption of the Asian financial crisis has derailed the planned adoption of the amendment to the Articles of Agreement, and reopened the debate on the virtues of globalisation, as well as on the preconditions that need to be in place for a "safe opening" of the capital account. In view of the policy lessons that have been learned, and in view of the fact that the world financial system (including that in emerging economies) is much stronger than what it used to be, I believe that the time has come for the reopening of the discussion that would lead towards capital account convertibility and that would necessitate the adoption of the relevant amendment to the Articles of Agreement of the IMF.