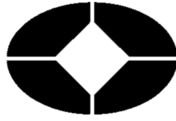

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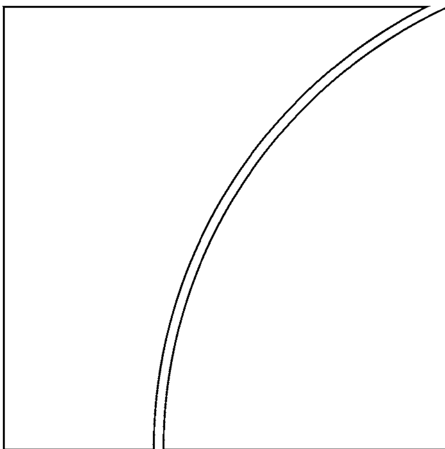
The future of financial globalisation

11th BIS Annual Conference
21–22 June 2012



Monetary and Economic Department

December 2012

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Foreword

The BIS 11th Annual Conference took place in Lucerne, Switzerland on 21–22 June 2012. The event brought together senior representatives of central banks and academic institutions, who exchanged views on the conference theme of "The future of financial globalisation". This volume contains the opening address of Stephen Cecchetti (Economic Adviser, BIS), a keynote address from Amartya Sen (Harvard University), and the available contributions of the policy panel on "Will financial globalisation survive?". The participants in the policy panel discussion, chaired by Jaime Caruana (General Manager, BIS), were Ravi Menon (Monetary Authority of Singapore), Jacob Frenkel (JP Morgan Chase International) and José Dario Uribe Escobar (Banco de la Repubblica).

The papers presented at the conference and the discussants' comments are released as BIS Working Papers 397 to 400.

Programme

Thursday 21 June 2012

12:15-13:30		Informal buffet luncheon
13:45-14:00		Opening remarks by Stephen Cecchetti (BIS)
14:00-15:30	**Session 1:**	**Revisiting the costs and benefits of financial globalisation**
	Chair:	Gill Marcus (Governor, South African Reserve Bank)
	Author:	Philip Lane (Trinity College Dublin) "Financial Globalisation and the Crisis"
	Discussant:	Dani Rodrik (Harvard Kennedy School)
	Coffee break (30 min)	
16:00-17:30	**Session 2:**	**Financial globalisation and the Great Leveraging**
	Chair:	Alexandre Tombini (Governor, Banco Central do Brasil)
	Author:	Alan Taylor (University of Virginia)
		"The Great Leveraging"
	Discussants:	Barry Eichengreen (University of California, Berkeley) Y Venugopal Reddy (Former Governor, Reserve Bank of India - University of Hyderabad)
18.00	**Departure from the Palace hotel for dinner venue (Mount Pilatus)**	
19:30	**Dinner**	
	Keynote lecture: Amartya Sen (Harvard University)	

Friday 22 June 2012

09:00-10.30	**Session 3:**	**Financial globalisation in a world without a riskless asset**
	Chair:	Erdem Basçi (Governor, Central Bank of Turkey)
	Author:	Pierre Olivier Gourinchas (University of California, Berkeley) and Olivier Jeanne (Johns Hopkins University) "Global Safe Assets"
	Discussants:	Peter Fisher (BlackRock) Fabrizio Saccomanni (Director General, Banca d'Italia)
	Coffee break (30 min)	
11:00-12.30	**Session 4:**	**Financial globalisation and monetary policy**
	Chair:	Masaaki Shirakawa (Governor, Bank of Japan)
	Author:	Hyun Song Shin (Princeton University) "Capital Flows and the Risk-Taking Channel of Monetary Policy"
	Discussants:	John Taylor (Stanford University) Lars Svensson (Deputy Governor, Sveriges Riksbank)

12.30	**Lunch**	
	Speaker:	Jean-Claude Trichet (former ECB President, Chair G30)
14:00-15:30		**Panel discussion**
		"Will financial globalisation survive?"
	Chair:	Jaime Caruana (BIS)
	Panellists:	Ravi Menon (Managing Director, Monetary Authority of Singapore)
		Jacob Frenkel (Chairman, JP Morgan Chase International)
		José Dario Uribe Escobar (Governor, Banco de la República)

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Is globalisation great?

Stephen Cecchetti[1]

It is my pleasure and privilege to welcome all of you to the 11th BIS Annual Conference. This year our theme is the future of financial globalisation. Anyone who has lived through the last five years must surely ask: Is globalisation great? Given the orientation of the BIS, we are forced to ask this question. In fact, I am led to ask two questions, namely: How much globalisation is good? And how much finance is good? Over the next two days we will reflect on these issues. Let me give you my answers to my questions up front: financial deepening is great, but only up to a point. And this means that the globalisation of finance is great, too – but only up to a point.

To see why I have come to these conclusions, I will take a minute to describe the relationship of finance to growth in general, and then draw out implications for cross-border banking; that is, the part related to the globalisation of finance. My comments build on work that has been going on at the BIS for some time.[2]

For most people, the term globalisation means cross-border trade in real goods and services; something that we would all agree has brought the greatest benefits to a large number of people. Trade very clearly supports middle-class living standards, among other things putting literally tens of thousands of different products on the shelves of even a modest-sized supermarket.

But this real side of globalisation relies on financial intermediaries to fund the trading of all this stuff across borders. And the recent crisis showed how problems both on and off the intermediaries' balance sheets can have very large, very real and very bad implications. Many of us have started to ask if finance has a dark side.

First, can a financial system get too big? Put differently, is there some optimal size for the financial industry beyond which it drags down the rest of the economy? Second, how far should countries go in outsourcing the provision of financial services? Does specialisation in financial services by some countries impose vulnerabilities on others? How we think about and answer these questions will surely have an impact on the financial system's structure and thus on the future of globalisation.

Turning to some facts, consider the relationship between the size of a country's financial system and growth. We teach that, because it allocates scarce resources to their most efficient uses, one of the best ways to promote long-run growth is to promote financial development. And a sufficiently well developed financial system provides the opportunity for everyone – households, corporations and governments – to reduce the volatility of their consumption and investment.

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[1] Economic Adviser at the Bank for International Settlements (BIS) and Head of its Monetary and Economic Department. The author would like to thank Robert McCauley and Patrick McGuire for their contributions to this presentation. The views expressed here are those of the author and do not necessarily reflect those of the BIS.

[2] See, for example, the original work in C Borio and P Lowe, "Assessing the risk of banking crises", *BIS Quarterly Review*, December 2002, pp 43–54, and C Borio and P Lowe, "Securing sustainable price stability: should credit come back from the wilderness?", *BIS Working Papers*, no 157, July 2004.

It sure sounds like finance is great. But experience shows that a growing financial system is great for a while – until it isn't. Look at how, by encouraging borrowing, the financial system encourages an excessive amount of residential construction in some locations. The results – empty three-car garages in the desert – do not suggest a more efficient use of capital!

Financial development can create fragility. When credit extension goes into reverse, or even just stops, it can induce economic instability and crises. Bankruptcies, credit crunches, bank failures and depressed spending are now the all too familiar landmarks of the bust that follows a credit-induced boom.

What is more, financial development is not costless. The expansion of finance consumes scarce resources that could be used elsewhere. And finance's large rewards attract the best and the brightest. When I was a student, my classmates dreamed of curing cancer, unifying field theory or flying to Mars. Those in today's cohort want to become hedge fund managers. Given finance's booms and busts, is this the most efficient allocation for such scarce resources? I doubt it.

So, when does financial deepening turn from good to bad and become a drag on the economy? Somewhat surprisingly, we get a consistent story regardless of how we measure financial development.

In our 2011 paper for the Federal Reserve Bank of Kansas City's Jackson Hole Symposium, Madhu Mohanty, Fabrizio Zampolli and I found that the effect of debt – public, household or corporate – turns from good to bad when it reaches something like 90% of GDP, regardless of the type of debt.[3] To prevent adverse developments – both natural and man-made – policy should normally strive to keep debt levels well below this line.

If we measure the scale of the financial industry by employment or output, as Enisse Kharroubi and I do in a paper completed earlier this year, we come to the same conclusion.[4] When average growth in output per worker is plotted, as shown in Graph 1, against the share of employment in finance on the left and value added on the right, a parabola summarises the scatter. (Note that a multivariate regression lies behind these graphs, so that the parabola is a slice out of a more complex surface.) Again, the conclusion emerges that there is a point where both financial development and the financial system's size turn from good to bad.[5] That point lies at 3.2% for the fraction of employment and at 6.5% for the fraction of value added in finance. Based on 2008 data, the United States, Canada, the United Kingdom and Ireland were all beyond the threshold for employment (4.1%, 5.7%, 3.5% and 4.5%, respectively). And the United States and Ireland were also beyond the threshold for value added (7.7% and 10.4%, respectively).

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[3] S Cecchetti, M S Mohanty and F Zampolli: "The real effects of debt", paper prepared for the "Achieving Maximum Long-Run Growth" symposium, sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 25–27 August 2011. A revised version including the underlying data (in XLS) is available as *BIS Working Paper* no 352, September 2011.

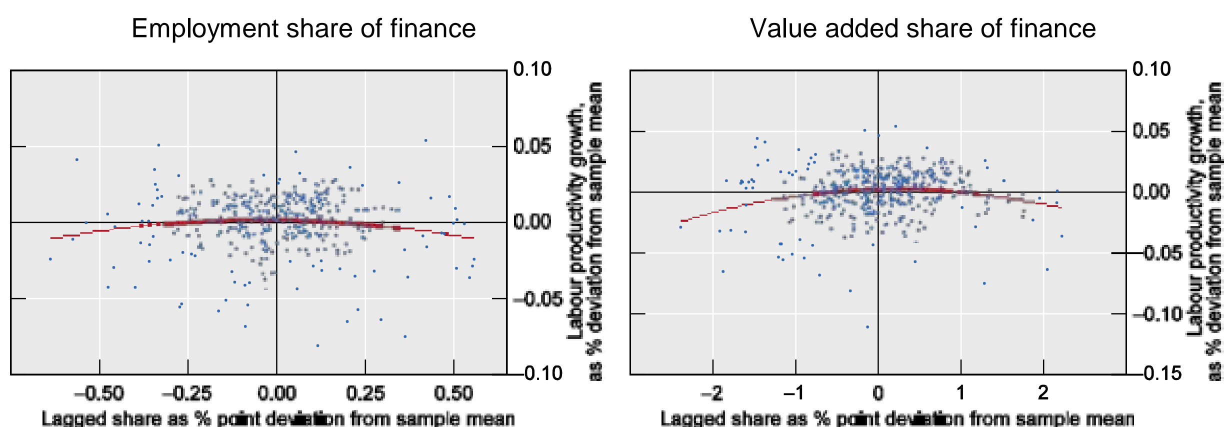
[4] S Cecchetti and E Kharroubi, "Reassessing the impact of finance on growth", mimeo, January 2012.

[5] The picture using credit-to-GDP yields the now familiar result of a peak at around 100% of GDP.

Graph 1

Productivity growth and financial sector share

(16 OECD countries, 1980–2009)



The left- (right-) hand scatter plot represents the partial relationship between labour productivity growth and the employment (value added) share of finance, controlling for investment to GDP, employment growth, openness to trade, initial labour productivity and country-specific dummies.

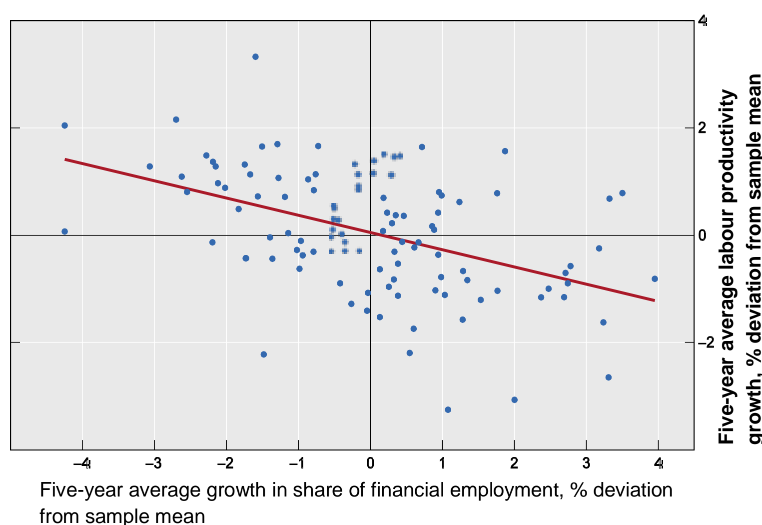
Source: Cecchetti and Kharroubi (2012) based on OECD, *Economic Outlook* and OECD, *STAN*.

Moreover, the evidence suggests that a growing share of the financial system actually slows overall economic growth. Financial sector booms consume scarce resources, especially skilled labour and specialised capital. Panel regressions of the five-year average growth rate of labour productivity on, among other variables, the growth rate of the share of finance in total employment yield the strong negative relationship displayed in Graph 2.

Graph 2

Productivity growth and growth in the financial sector

(16 OECD countries, 1980–2009)



This scatter plot represents the partial relationship between labour productivity growth and the growth rate of the employment share of finance, controlling for investment to GDP, employment growth, openness to trade, initial private credit to GDP, initial labour productivity and country-specific dummies.

Source: Cecchetti and Kharroubi (2012) based on OECD, *Economic Outlook* and OECD,*STAN*.

Faster-growing financial employment hurts average productivity growth, as does "too much" value added. In particular, a 1 percentage point increase in the growth rate in finance's share of employment cuts average productivity growth by nearly one third of a percentage point per year.

Combined, these facts lead to the inescapable conclusion that, beyond a certain point, financial development is bad for an economy. Instead of supplying the oxygen that the real economy needs for healthy growth, it sucks the air out of the system and starts to slowly suffocate it. Households and firms end up with too much debt. And valuable resources are wasted. We need to do something about this.

If financial development is only good up to a point, it follows that financial globalisation might only be good up to a point. Financial globalisation is about making it irrelevant to investors and borrowers where the services and the funds they draw on are actually located. But the spillovers during the financial crisis, when one country's troubles spread to others, raise the question: does it matter where the funds are coming from? That is, how should we think about cross-border flows and financial specialisation?

As economists, we are trained to think that specialisation is great. Within an economy, we believe that when individuals exploit comparative advantage, it benefits everyone. And, we have created an entire infrastructure where, for example, I am able to write and speak about macroeconomic and financial stability policy full-time, but still purchase groceries. The alternative, where I would barter my insights for food, would surely not work as well.

I'll let you be the judge of whether, in my specific case, the market is yielding the right social solution. But for the world as a whole, global welfare is enhanced when we encourage international trade in goods and services. And international trade benefits emerging and advanced countries alike when it exploits comparative advantage. Which inevitably leads to specialisation.

Trade and specialisation reach their limits where economics meets national security. As an individual, I can rely on someone else to produce my food, trusting that some combination of the market and the legal system will look out for me. But would a country want to outsource its entire food production? And what about energy?

National security concerns dictate that some amount of self-sufficiency is cultivated, simply as a precaution. Some concern about food and energy security is certainly warranted. The same is probably true for strategic technologies. But clothing or coffee security is probably not worth worrying about. Where does finance stand on this spectrum between the essential and the superfluous? More specifically, can countries become vulnerable by excessively specialising in finance or by overly relying on people outside their borders for the provision of financial services? Has financial globalisation gone too far in some countries?

Over the past 30 years, the international financial system has come to be dominated by a relatively small number of large banks headquartered in a handful of advanced counties. Their growth has coincided with a push to remove impediments to the free flow of capital. As a result, a highly concentrated banking sector dominates the international provision of capital and maintains large balance sheet positions with respect to many countries. And when these balance sheet linkages are large (relative to GDP or the capital stock or the domestic tax base), problems in one country's financial sector quickly transmit themselves to other countries and markets. In short, financial globalisation is bound up with a specialisation in financial services that makes countries much more vulnerable to each other's mishaps.

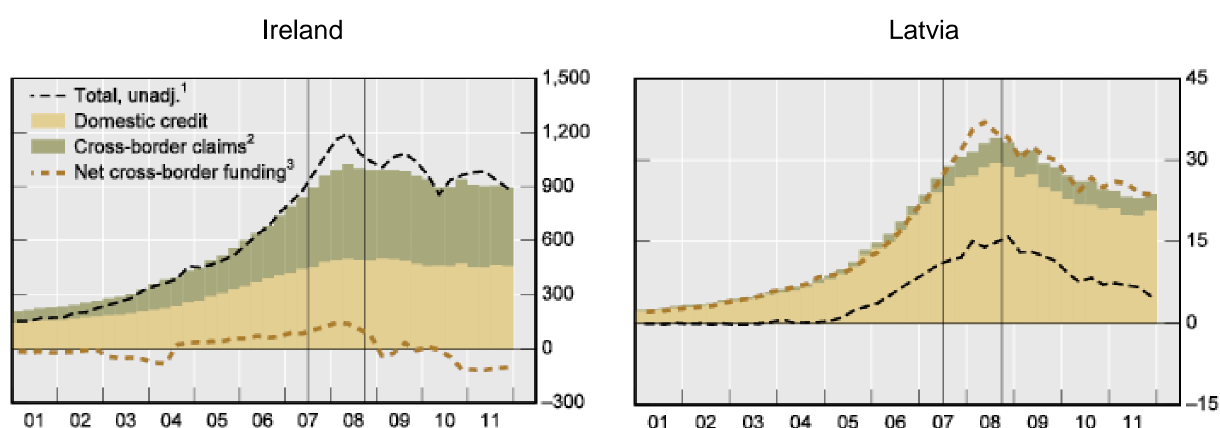
The experience of some countries during the crisis suggests that too much international capital, like too much debt, can be bad. For example, credit booms in the years preceding the crisis tended to outrun domestic funding and to depend on funds from abroad at the margin. Countries that relied heavily on international credit sources to finance domestic booms found themselves high and dry when these offshore sources of funding went into reverse – which happened as soon as the foreign creditor banks ran into trouble.

A few examples illustrate just how important cross-border credit can become. Graph 3 shows the cases of Ireland and Latvia.[6] The light shaded areas depict credit provided by domestic banks to non-bank borrowers, that is, domestic credit. As you can see from the picture, Ireland's non-bank borrowers also directly tapped cross-border bank credit (shown here as the green shaded area). Such credit – which bypasses the domestic banking system and, as a result, is difficult for local authorities to monitor, much less to constrain – accounted for almost half of total credit to non-financial borrowers in Ireland during the last decade!

Graph 3

Bank credit to non-banks

(at constant end-Q4 2011 exchange rates)



[1] The stacked bars indicate total bank credit expressed in US dollars at constant end-Q2 2011 exchange rates, and thus exclude valuation effects. The dotted black line shows unadjusted total bank credit converted into US dollars at contemporaneous exchange rates. [2] BIS reporting banks' cross-border claims on non-banks. Claims include loans and securities, most of which is debt. [3] Net cross-border borrowing (liabilities minus claims) from all sectors by banks located in the country. For Latvia (a non-BIS reporting country), BIS reporting banks' net cross-border claims on banks in the country.

Sources: IMF, *International Financial Statistics*; BIS locational banking statistics; BIS consolidated banking statistics.

International credit can also flow into a booming economy indirectly. In Latvia, shown in the right-hand panel of Graph 3, banks financed their domestic credit expansion by borrowing from abroad. This indirect financing of domestic credit is shown as the dashed brown line. While the credit was actually extended by domestic banks (or local subsidiaries of foreign banks), the funds were raised cross-border.

This indirect form of international credit – from a foreign bank to a domestic bank and then on to a domestic borrower – is often overlooked when people analyse credit booms. However, by some measures, it is at least as important as direct cross-border credit. Graph 4 shows on the vertical axes the change in the credit-to-GDP ratio in emerging markets between 2002 and 2007. In the left-hand panel, the horizontal axis plots the change in direct cross-border credit; in the right-hand panel, the horizontal axis plots direct plus indirect cross-border credit.

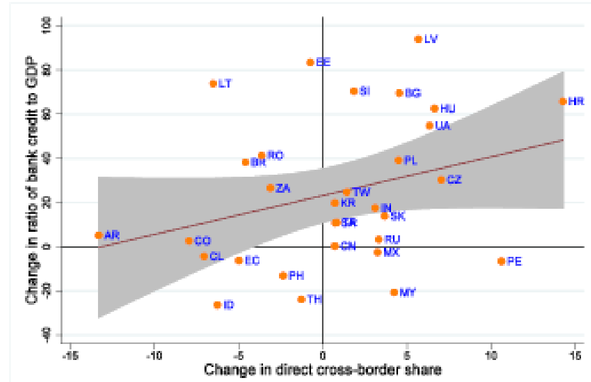
[6] Taken from S Avdjiev, R McCauley and P McGuire, "Rapid credit growth and international credit: challenges for Asia," *BIS Working Papers*, no 377, April 2012.

Graph 4

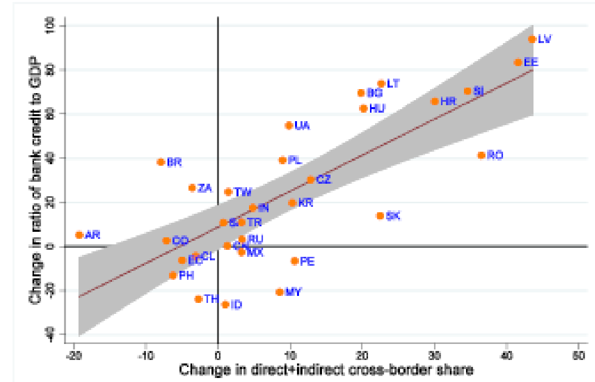
International credit and credit expansion in emerging markets (Q1 2002–Q2 2008)[1]

In per cent

Direct cross-border credit[2]



Direct plus indirect cross-border credit[3]



[1] The y-axis shows the change in the ratio of total bank credit (including credit to governments) to GDP over the Q1 2002–Q2 2008 period. Total bank credit is the sum of domestic credit and cross-border bank credit to non-banks in the country. The red lines indicate OLS-predicted values and the grey areas indicate the 95% confidence bands for these regression lines. [2] The x-axis shows the change in the ratio of direct cross-border credit over total bank credit to non-banks (including governments). [3] The x-axis shows the change in the ratio of direct cross-border credit plus net cross-border borrowing by banks in the country (if positive) to total bank credit to non-banks.

Source: Avdjiev, McCauley and McGuire (2012).

The faster cross-border credit grows, the faster domestic credit grows. And, the relationship in the right-hand panel including indirect cross-border credit is much stronger both statistically and economically. A 1 percentage point increase in direct and indirect cross-border credit is associated with a 1.6 percentage point increase in the ratio of credit to GDP. While, in principle, financial overdevelopment and financial globalisation may be orthogonal, in practice, cross-border finance seems to be implicated in financial overdevelopment.

After trying to convince you that finance is only great up to a point, I have tried to persuade you that the same may apply to financial globalisation, at least in the form of cross-border banking. It provides us with opportunities, but there are also some pitfalls. As is often the case, you can have too much of a good thing. But I have less compelling evidence here, so I am left with a more tentative conclusion: financial globalisation is great most of the time but not always.

During the conference, Philip Lane, in his paper on financial globalisation and the crisis, digs deeper into the role of global imbalances in driving cross-border balance sheet integration in the pre-crisis years. Then, Alan Taylor systematically studies the relationship between credit and financial crises over the long haul. Tomorrow morning, Pierre-Olivier Gourinchas and Olivier Jeanne offer us a view into a world in which safe and unsafe assets fight for room in global portfolios. And, finally, Hyun Song Shin, in his paper with Valentina Bruno, provides a model for cross-border capital flows, including their dark side. These presentations and the discussions that they spawn will give us new perspectives on the positive and normative aspects of financial globalisation. We hope to come away with a better understanding of both what may happen and what should happen to ensure that financial globalisation makes a positive contribution to growth and world welfare.

Thank you all for coming, and I look forward to the next day and a half of discussion.

What has happened to Europe?

Amartya Sen

I.

About 50 years ago, in 1961, Jean-Paul Sartre complained about the state of Europe. "Europe is springing leaks everywhere," he wrote in the preface to his book, *The Wretched of the Earth*. He went on to remark: "It simply is that in the past we made history and now history is being made of us." Sartre was undoubtedly too pessimistic. Many major achievements of great significance have occurred in the last half a century in Europe, since Sartre's lament, including the emergence of the European Union, the reunification of Germany, the extension of democracy to eastern Europe, the consolidation and improvement of national health services and of the welfare state, and the legal codification and enforcement of some human rights. All this went with a rapidly expanding European economy, which comprehensively rebuilt and then massively expanded its war-damaged industrial base and infrastructure.

There is indeed a long-run historical contrast to which Sartre could have been referring. For centuries preceding World War II, a lot of world history was actually made in Europe. If that generated much admiration mixed with some fear around the world, the situation changed rapidly in the second half of the 20th century. When I first arrived in Cambridge as a student from India in the early 1950s, I remember asking whether there were any lectures given at Cambridge University on the economic history of Asia, Africa and Latin America. I was told that there were indeed such lectures, and they were given for a paper called "Expansion of Europe". That view of the non-European world would seem a little archaic now, not merely because the grand European empires have ended, but also because the balance of political prominence and economic strength has radically changed in the world. Europe is no longer larger than life.

There is, of course, nothing particularly remarkable – or lamentable – in the changing role of the different regions of the world with the progress of history. This has happened again and again in the annals of the world. What is really striking is not the historical rebalancing of the different parts of the world, but the mess that Europe has managed to get into in the last decade or so, particularly over the last couple of years. There is a lot of discussion right now on how Europe is going to liberate itself from its financial disarray, economic misery and political chaos. "What to do now" is certainly an important issue today (not least in this symposium), but "what not to do" is also an important question in looking at Europe's immediate past. This is important not just because past mistakes are relevant in deciding on what to do here and now in Europe (even though what has been done cannot be readily "undone" – there is never any automatic translation from past follies into present rectifications) – but also because the negative lessons are important to avoid similar adversities in the rest of the world.

II.

So what has gone wrong in Europe in the recent years? I shall divide my analysis into three broad subjects: (i) the challenge of European unity, (ii) the requirements of democracy, and (iii) the demands of sound economic policy. These topics are interrelated.

The unification of Europe is an old dream. It is not quite as old as it is sometimes suggested – the dream is not of classical antiquity. Alexander and other ancient Greeks were less

interested in chatting with Goths, Vikings, Angles and Saxons than they were in conversing with ancient Iranians, Bactrians and Indians. In the same way, Julius Caesar and Mark Anthony identified more readily with ancient Egyptians than with fellow Europeans located to the north or west of Rome. But Europe went through successive waves of cultural and political integration, greatly helped by the powerful spread of Christianity, and by 1464 King George of Poděbrady in Bohemia was talking about pan-European unity. He was followed by many others in the centuries to follow, and in the 18th century George Washington wrote to the Marquis de Lafayette, "One day, on the model of the United States of America, a United States of Europe will come into being."

However, it was the two world wars in the 20th century, with a flood of European blood, that firmly established the urgent need for the political unity of Europe. As W H Auden wrote in early 1939, on the eve of World War II:

> In the nightmare of the dark
> All the dogs of Europe bark,
> And the living nations wait,
> Each sequestered in its hate.

And the events to follow only confirmed Auden's worst expectations. The terrible fear of a repeat of what European countries had seen in these world wars continued to haunt a great many thoughtful Europeans. It is important in this context to appreciate that the movement for European unification began as a crusade for political unity, rather than for a financial unification or a common currency.

The birth of the European Federalist movement was motivated strongly by the desire for political unification – and freedom from self-destructive wars – as the content both of the Ventotene declaration of 1941 and of the Milan declaration of 1943 bring out very clearly. There was no hostility to economic integration and not even to a financial union; however, the priority was not banking or a single currency, but peace and goodwill and a gradually evolving political integration. The fact that the political unification has fallen way behind financial incorporation is a later development, and the problems generated by that chosen sequencing is not, I will argue, irrelevant to understanding the complex nature and extensive reach of the present economic crisis in Europe.

One point is particularly important to note in this historical context, especially since it is often missed. The problems created in the euro zone by going first for the currency integration and inaugurating a monetary union without the supportive presence of a closer political union and a fiscal union extend well beyond economic mishaps into social adversities among people in different European countries. Anger and frustration, in many different forms, have generated tension between countries with differential fortunes within the euro zone, and have also fomented extremist politics of a kind that Europe would have hoped to have left behind.

There is nothing particularly surprising about the balance of payments problems and other economic adversities that many of the European countries – Greece, Spain, Portugal – have faced, owing to the inflexibility of the euro zone restrictions on exchange rate adjustment and monetary policies. The consequent scenario of crises and rescues involving demands for draconian cuts in public services has also frayed people's tempers on both sides of the divide. It has strongly exacerbated international disaffections within Europe, as is clear from the political rhetoric heard in recent days, in very different forms, from the north as well as the south of Europe – with pejorative anger targeted at objects of contempt that vary from "lazy Greeks" to "imperial Germans".

An often-invoked analogy with German sacrifices to achieve the unification of East and West Germany, which clouds at least some European thinking, is thoroughly misleading here. This is partly because the sense of national unity that prompted the German sacrifice does not exist, at this time, between the different European nations, but also because the sacrifice in that remarkable exercise of national unity fell mostly on the richer part of Germany, not on

the poorer components, as is being demanded right now from many of the afflicted European countries, from Greece to Spain.

The costs of failed economic policies extend well beyond the statistics for unemployment, real income and poverty (important as they are). The grand vision of a union with a cementing sense of European unity is itself threatened by what is going on in the economic arena. Those who advocated a "unity of a European currency" as a first step towards a united Europe have, in fact, pushed much of Europe into an entirely counterproductive direction for achieving European unity. There is, of course, no danger of a return to 1939, but, to use the analogy of Auden, the "dogs of Europe" barking from sequestered regional bases of resentment and contempt – if not hate – do immense harm to the cause of cultivating European amity and unity.

III.

I turn now to democracy. The founders of European unity, whose ideas moved the European Movement, wanted a "united democratic Europe". The Europe that emerged from World War II had learned certain things from bitter experience that it was not going to forget. Perhaps the foremost idea was the importance of democracy, giving each person not only a vote but also a voice. If democracy in the form of periodical elections is firmly instituted in the constitutions of most European countries, the commitment to have preparatory public discussions before taking large policy decisions is no less ingrained in contemporary European values. Walter Bagehot defined democracy as "government by discussion" – following a line of political analysis that John Stuart Mill had done much to clarify and champion – and the visionary leaders initiating the quest for European unity never wavered from this commitment.

I shall presently argue that some of the policies that were chosen by the financial leaders and economic powers of Europe were certainly mistimed, if not downright mistaken. But even if the policy decisions taken by the financial experts were exactly correct and rightly timed, an important question of democratic process would remain. For example, the decimation of something as fundamental as the public services that are essential pillars of the European welfare state could not be appropriately left to the unilateral judgments of financial experts (not to mention the error-prone rating agencies) without public reasoning and the informed consent of the people of the countries involved. It is, of course, true that financial institutions are extremely important for the success and failure of economies, but if their views were to have democratic legitimacy, that must be through a process of public discussion and persuasion, involving arguments, counterarguments, and counter-counterarguments.

If democracy has been one of the strong commitments with which Europe emerged from the 1940s, an understanding of the necessity of social security and avoidance of intense social deprivation has surely been another. Even if savage cuts in the foundations of the European systems of social justice had been financially inescapable (I don't believe they were, but even if they had been), there is a need to persuade people that this is indeed the case, rather than trying to carry out such cuts by fiat. The disdain for the public could hardly have been more transparent in many of the chosen ways of European policymaking.

Quite aside from that question of democratic legitimacy, there is also an important issue here of political practicality – the practice of the "art of the possible" (as politics is meant to be). People could be denied their voice, but given the democratic institutions, they could not be denied their votes in periodic elections. Not surprisingly the people excluded from taking part in the process of policymaking could not be politically silenced, and in election after election, the incumbent governments carrying out the dictates of financial superpowers have been deeply threatened and sometimes summarily removed. And voting rights without an effective policy voice have also made it very difficult for practical solutions to emerge, with appropriate

attention to well considered priorities and to acceptable give and take. Public reasoning is not only crucial for democratic legitimacy, but also for better epistemology when considering divergent perspectives. It is also essential for more effective practical reasoning that can bring out which particular demands and protests can be restrained in interactive public reasoning, in line with scrutinised priorities between a cluster of quite distinct demands (a process of "give and take" that many political analysts from Adam Smith and the Marquis de Condorcet in the 18th century to Frank Knight and James Buchanan in our time have made us appreciate better).

IV.

I move now to the soundness of economic policymaking. There are two issues that arise immediately: (i) the viability of the common European currency, the euro, and (ii) the policy of austerity – chosen by or imposed on European countries in financial difficulty. On the first question, most of the attention has tended to be concentrated on the short-run survival of the euro, through providing liquidity to the troubled countries by one means or another. Many alternative rescue efforts are being considered right now, such as new bailout packages supported by the financially stronger countries, or the floating of guaranteed euro bonds, or the purchase of Greek, Spanish other high-interest bonds from troubled countries by Germany (thereby earning high interest, without much risk, so long as the euro survives in its present form). Many of these rescue proposals are worth considering and may prove useful, but none of them address – or are meant to address – the long-run viability problem arising from the inflexibility of the exchange rate through the shared euro, even as countries with relatively lower productivity growth (such as Greece or Spain or Italy) fall behind other countries in the euro zone in terms of their trade competiveness. A country such as Greece, may find that it has less and less to offer for sale at the fixed exchange rate of the euro, unless what is not done by exchange rate adjustment is brought about by the brutal process of cutting wage rates – even in terms of the national currency – to an extent that would not be otherwise necessary.

In the absence of exchange rate adjustments, competitiveness for the countries falling behind can be recovered through sharp wage cuts and other such ways of cutting earnings, thereby further reducing living standards. This would inflict much suffering and invite an understandable resistance. There would also be resistance to the other solution, through increased migration of the population (for example from Greece to Germany). A unified currency in a politically united federal country (such as in the United States) survives through means (such as substantial population movements and significant transfers) that are not available to a politically disunited Europe. Sooner or later the difficult question of the long-run viability of the euro would have to be addressed, even if the rescue plans are completely successful in preventing a breakdown of the euro in the short run.

I turn now to the second issue, concerning the effectiveness of austerity in cutting public expenditures in steering the countries in difficulty out of their immediate problem of excessive deficits and huge debts. It is difficult to see austerity as a soundly reasoned economic solution to the European malaise today. And it may not even be a good way of reducing public deficits.

The policy package demanded by the financial leadership of Europe has been, despite its rhetoric, severely anti-growth. The economic growth of the euro zone has been faltering so much and even the GDP has been falling so firmly (it declined even in the fourth quarter of 2011) that the recent report that there was zero growth in the euro zone in the first quarter of 2012 has been widely greeted as good news. And if Germany is taken out of the total, the result would be continued bad news of falling output in the rest of euro zone. Spain, Portugal and Italy continued to decline in these months, and while Greece tempered its free fall from a previous negative 6% (in 2011); the Greek economy has lost nearly a quarter of its

production since 2008. While the economies and the people involved have suffered, the deficits have been quite resistant.

There is, in fact, plenty of evidence in world history that indicates that the most effective way of cutting deficits is to resist recession and to combine deficit reduction with rapid economic growth. The huge deficits after World War II largely disappeared thanks to fast economic growth in the post-war years. Something similar happened during the eight years of Clinton's presidential terms, when Clinton began with a huge deficit and ended with none. The much praised reduction of the Swedish budget deficit during 1994–98 occurred in a period of fairly rapid GDP growth. The situation is very different today for many countries asked to cut the deficit that have zero or negative growth rates under an imposed discipline of austerity heaped on a recession.

V.

That austerity is a counterproductive economic policy in a situation of economic recession can be seen, rightly, as a "Keynesian critique". Keynes did argue, and persuasively so, that, when an economy has unused productive capacity owing to an effective demand deficiency, to cut public expenditure would tend to have the effect of further slowing down the economy and increasing – rather than decreasing – unemployment. Keynes certainly deserves much credit for making that rather basic point clear even to policymakers, irrespective of their politics, and he also provided what I would call a sketch of a "theory" – I won't go further than that – of explaining how all this can be nicely captured within a general understanding of economic interdependences between different activities (emphasising in particular the fact that someone's expenditure is another person's income). I am certainly supportive of that Keynesian argument and, to the extent that Paul Krugman has made an excellent contribution in developing and propagating that important perspective in questioning the ongoing policy of massive austerity in Europe, I am strongly appreciative of his work as well.

The Keynesian perspective remains important and yet I would argue that the austerity policies should be judged inappropriate only partly for Keynesian reasons. Where we have to go well beyond Keynes is in asking what public expenditure is for – other than for just strengthening effective demand, no matter what its content. As it happens, European resistance to savage cuts in public services and to indiscriminate austerity is not only not based on – or, at least, not primarily based on – Keynesian reasoning, but more importantly, this resistance is making a constructive point about the importance of public services that is of great economic as well as political interest in Europe. There is a central issue of social justice involved here – that of reducing rather than enhancing injustice (the form that the theory of justice inescapably has to take, as I have argued in my book, *The Idea of Justice*). Public services are valued for what they actually provide to the people, especially vulnerable people, and this is something for which Europe has fought. Savage cuts in these services undermine what had emerged as a social commitment in Europe at the end of World War II, and which led to the birth of the welfare state and the national health services in a period of rapid social change in that continent, setting a great example of public responsibility from which the rest of the world – stretching from East Asia to Latin America – would learn.

In order to understand the inadequacy of Keynes as a guide to solving the European economic crisis, we have to ask: what kind of an economist was Keynes in terms of his vision of a good society? Keynes did say – famously and again accurately enough – that paying labourers to dig holes and then to fill them up again can be a very good thing, because of its impact on increasing effective demand to combat a recession or a depression. This is fair enough, but Keynes had extremely little to say on what social commitments a state should have – what should the public expenditure be for, other than just for strengthening market demand through state intervention.

Keynes said very little on economic inequality. He was also extraordinarily reticent on the horrors of poverty and deprivation, had little interest in externalities and the environment, and neglected altogether the subject that his rival and adversary A C Pigou concentrated on, to wit, *The Economics of Welfare*, which was the title of Pigou's most famous and certainly most profound book. It was the allegedly right-wing Pigou who initiated the measurement of economic inequality, spent time analysing the nature and causes of poverty, and wrote extensively on externalities and environmental degradation, and the need for public economics to remedy the allocational errors of the market economy.

VI.

So the need to question the ongoing financial policies in Europe arises for economic reasons that go beyond Keynes (while incorporating some ideas of Keynes), in addition to the political and social reasons to which I have also tried to point. This scepticism does not in any way question the need to recognise the importance of reducing, in an appropriate time frame, the burden of public debt. But good economics is not only about what to aim at, but also about what can be effective, and how and when.

If we add to this economic argument the long-term concern in Europe about some form of social justice and the more immediate political worry about the undermining of the sense of European sense of solidarity, we can see what a disaster the recent European financial policies have been. This is not to say that commitments to social justice are always paramount, but it is surely a serious concern that cannot be brushed aside by unilateral decisions of financial leaders – no matter how high or low their standing might be in their limited world. There is always a need for rational scrutiny and examination of what a country can afford and what it cannot (taking into account all relevant factors, including the changing age distribution of the population), but this is not the same question as checking what a country can afford with inefficient economic and financial management – of the kind that Europe has plentifully experienced recently, with fuzzy thinking on exchange rates and market demands and economic competitiveness.

The guiding principle has to be, rather, what Adam Smith specified with much clarity in *The Wealth of Nations*: how to strive for the good functioning of the economy in order to be able to provide the public services that people agree are needed, along with enhancing the private means that people enjoy from employment and income. Good political economy, Smith argued, has to have "two distinct objects": "first, to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the state or commonwealth with a revenue sufficient for the public services."

Finally – and importantly – serious consideration of the kinds of reform that are needed in Europe has, in fact, been hampered, rather than aided, by the loss of clarity on the distinction between (i) reform of bad administrative arrangements, and (ii) austerity in the form of ruthless cuts in public services and basic social security. Europe does need many economic reforms of different types, such as the stopping of tax evasion, preventing government servants from using favouritism in the exercise of their powers, regulating banks that are tempted to act irresponsibly – or worse – in the unrestrained pursuit of their own gain (sometimes biased heavily towards short-run profits), and changing retirement ages that are economically hard to sustain. The requirements for alleged financial discipline have tended, in unclear analysis, to amalgamate the two, even though any scrutiny of the demands of social justice would view policies for necessary reform in an altogether different way from indiscriminate cuts in important public services. Even if that distinction may have been lost in some rather crude financial thinking, opportunities for adequate public discussion in "governance by discussion" could have brought out its relevance clearly enough.

Europe has been extraordinarily important for the world, which has in turn learned so much from Europe. Europe can remain globally important by setting its own house in order, economically, politically and socially. This is important not just for Europe but for the world.

Introductory and closing remarks for the panel session on "The future of financial globalisation"

Jaime Caruana[1]

This is the last session of a very interesting conference in which we've heard a wide range of views on the future of financial globalisation. In this panel, we have the opportunity to hear from extremely experienced practitioners who need no introduction. We will learn their views on what the future of financial globalisation means for central banks.

Let me introduce the discussion with four questions that arise from the papers presented yesterday and this morning. Panel members are welcome to give their views on issues other than those raised by these questions.

The first question relates to Philip Lane's paper about the channels through which financial globalisation has influenced the financial crisis. Overall, has financial globalisation been helpful or harmful in containing the effects of the crisis? What is your net cost-benefit assessment?

My second question is prompted by Pierre-Olivier Gourinchas's and Olivier Jeanne's comments about financial globalisation in a world without a riskless asset: can a structural reduction in the natural interest rate fully justify a continuation of extraordinarily accommodative monetary policy at the global level? Or, should central banks be aware of the distortions that a prolonged period of low interest rates might impose on balance sheet repair?

Related to this point, and drawing on the paper by Hyun Song Shin on capital flows and the risk-taking channel of monetary policy: what are the channels through which expectations of extraordinarily accommodative monetary policy conditions in advanced economies could reduce bank risk perception and stimulate cross-border banking sector capital flows in emerging market economies?

The last question is prompted by Alan Taylor's paper, which analyses the global financial crisis from a historical perspective: how should crisis prevention mechanisms be re-designed? What is the best way to deal with a financial capitalism that Alan names "the Great Leveraging"?

I am looking forward to hearing the panel's opinions – and, in particular, their views on the future of fiscal policy and its interactions with monetary and financial stability. I will not introduce the speakers, who are already very well known. I will follow the seating order, so I will ask Ravi Menon to give his presentation first.

* * *

Let me wrap up this interesting discussion with a personal view on how financial globalisation can affect monetary policy. This is very much related to the paper that Hyun Shin has presented this morning. In my view, the growing relevance of monetary policy spillovers

[1] General Manager, Bank for International Settlements.

caused by financial globalisation suggests that central banks need to take better account of the global implications of their actions.

Put differently, in an interconnected world, it may not be enough to keep one's own house in order, notwithstanding the importance of that aim in itself. Tightly integrated markets, and financial instruments across the world, mean that a country's economic and financial conditions are increasingly subject to global conditions. And those conditions, in turn, are influenced by the collective behaviour of markets and policymakers, even though they might appear independent of any one country's actions.

One simple example is how accommodative monetary conditions spread in the run-up to the recent crisis and are now spreading again. Unusually low policy rates in the core industrial countries in the years preceding the crisis were transmitted to the rest of the world through a reluctance to allow exchange rates to appreciate. The outcome was an unusually accommodative global monetary policy stance despite record global growth. This amplified the global credit and asset price boom, magnifying and extending the damage of the subsequent bust.

Currently, persistently large interest rate differentials support capital and credit flows to emerging market economies. These have put upward pressure on emerging market exchange rates. This makes it more difficult for emerging market central banks to pursue their domestic stabilisation objectives. As a result, monetary policy in emerging market economies may be systematically loose.

These considerations do not require a global coordination of monetary policies, but they do call for central banks to take better account of the global effects and feedbacks that arise from individual monetary policy stances. This will require a shift to a more global analytical approach to monetary policy, one that seeks to factor in interactions and feedback effects. Such a shift would resemble the move that has already occurred in regulation and supervision, from a micro- to a more systemic perspective. A frank exchange of views on the international dimension of domestic policies is a first step towards better domestic policymaking.

Financial globalisation: why, how and when?

Ravi Menon[1]

Introduction

Let me first thank the BIS for its excellent arrangements and warm hospitality.

I want to cover three broad areas in my remarks and, in doing so, at least partly address the questions that Jaime Caruana has posed us:

- First, I will revisit the costs and benefits of financial globalisation.
- Second, I will touch on the role that financial deepening and financial globalisation – and I want to make a distinction between these two – play in Asia's economic rebalancing and restructuring.
- Third, I will offer some thoughts on what needs to be in place before proceeding with financial globalisation.

Re-thinking financial globalisation

Financial globalisation has two main aspects:

- Free flow of capital into and out of the domestic economy.
- High foreign participation in domestic financial system.

Both aspects can be measured in many ways:

- Capital mobility: holdings of cross-border financial assets and liabilities, magnitude of cross-border flows into and out of the financial system.
- Foreign participation: foreign share of domestic banking assets and liabilities, ease of entry for foreign financial institutions into domestic market.

Financial globalisation along both dimensions, if well managed, can yield benefits for the economy.

- The purported benefits of open capital markets are well known, even if there is controversy around the significance of these benefits. For EMEs, the strongest benefit is the access that it provides to international capital.
- As for openness to foreign financial institutions, they play a critical function in credit intermediation, and maturity and risk transformation across national borders. They promote competition and innovation and introduce new technologies and best practices.

I come from a country that has benefited significantly from financial globalisation. But Singapore's experience cannot be generalised.

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[1] Managing Director, Monetary Authority of Singapore.

For most EMEs, financial globalisation is not costless and its benefits are not compelling.

Let's consider ***capital mobility*** first. There have been second thoughts about the benefits of unfettered capital flows.

Financial openness in itself does not bring about a crisis. John Taylor rightly reminded us yesterday that inappropriate monetary policies have played a big part in causing financial crises. Alan Taylor made a strong case for excessive credit expansion as a key causal factor.

But financial globalisation is the channel through which crisis contagion takes place. It raises risk of spillovers. The periodic transmission of financial crises tends to roll back the benefits from greater financial globalisation.

Well known research from Carmen Reinhart and Kenneth Rogoff suggests a positive correlation between banking crises and cross-border capital mobility. This is due in part to the procyclical nature of financial markets.[2]

Maurice Obstfeld takes the view that globalisation has gone too far, noting that "existing informational and institutional structure for global policymaking remains woefully inadequate to the challenge of financial globalisation."[3]

Dani Rodrik's comments yesterday alluded to this. Crisis contagion is so disruptive because we lack a system of international deposit guarantees and a global regime for bankruptcy and resolution.

International trade has a WTO to set and enforce the rules of the game. International finance does not.

So there is some truth in Rodrik's gun control analogy. Precisely because we cannot be sure that policies elsewhere will be appropriate, we need to be cautious about how open we are to channels through which the effects of bad polices abroad are transmitted to domestic financial system.

So much for capital mobility. What about foreign participation in the domestic financial system?

For reasons I highlighted earlier, the basic direction should be towards opening up financial sector, allowing for the presence of global players in domestic markets, but also putting in place appropriate financial stability safeguards.

Many of these safeguards are well known and universally accepted – sound regulation and rigorous supervision of financial institutions, having in place adequate capital and liquidity buffers, and improving transparency and corporate governance.

But I want to touch on two additional areas where more thought is required.

First, to what extent should foreign banks be allowed to take deposits, especially retail deposits, and especially through branches?

The universal branching model where branches of foreign banks are permitted to undertake a combination of retail, commercial and investment banking activities, without a need to legally separate these activities, has significant efficiency benefits for banks.

It allows them to take advantage of economies of scale by sharing management resources and capital across its business lines, and to pool risks across the banking group globally.

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[2] C Reinhart and K Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.

[3] M Obstfeld, "Financial flows, financial crises, and global imbalances", keynote address to the 15th International Conference on Macroeconomic Analysis and International Finance, University of Crete, Greece, May 2011.

For commercial and investment banking business, financial globalisation generally works well.

But when foreign bank branches have a significant share of domestic retail deposits, financial globalisation can be risky.

During periods of severe stress, the provision of essential services by a branch – especially to retail customers – could be disrupted.

Local retail depositors would be exposed to possible contagion or a crisis of confidence arising from problems in the bank's home market.

There is, therefore, a case for additional safeguards for retail deposit-taking by foreign banks – through limits on branching privileges or by imposing local incorporation requirements.

Second, to what extent should financial openness be limited by the prudential need for strong domestically anchored banks, whose interests are aligned with those of the domestic economy?

There is a proposition that banks with long-term interests aligned with the domestic economy will be more likely to act in support of the country's financial and economic stability.

In a crisis, strong, domestically anchored banks may be needed to undertake various roles.

First, they may be needed to acquire distressed financial institutions whose failure could have a systemic impact. The 2008 crisis provides some examples of this. In the United States, Bank of America took over Merrill Lynch, and JP Morgan took over Bear Stearns. And in the UK, Lloyds took over HBOS.

Second, strong and anchored banks may be needed to increase their role as key credit intermediaries in a crisis. This may include collaborating with the government to sustain lending to businesses in the real economy, where a credit freeze could result in business failures, job losses, and a more severe downturn.

To be clear, I am not advocating the protection of local banks and the building of local champions. My point is that we need to think hard about encouraging strong international banks to sink roots in our domestic economies in a way that strengthens their contribution to financial stability. Otherwise, financial openness carries high risks.

The role of finance in Asia's economic rebalancing

Next, I want to talk about the role of finance in the rebalancing and restructuring efforts of Asia.

Here, it is useful to distinguish between financial development and financial deepening on one hand and financial globalisation on the other.

Financial globalisation can contribute significantly to domestic financial development, but it is neither a sufficient nor necessary condition.

Domestic financial liberalisation and financial deepening can achieve most of the benefits of financial globalisation while mitigating the risks of contagion from abroad.

Empirical research has not found a clear link between financial globalisation and economic growth in EMEs,[4] but several studies have shown stronger and more convincing evidence of a causal relationship between domestic financial development and economic growth.[5]

From Asia's perspective, liberalising and deepening the financial markets is an important element in economic rebalancing and restructuring.

The new global economic landscape over next decade will be shaped by three fundamental forces:

- Deleveraging in advanced economies (AEs) – this will mean slower economic growth in AEs.
- Re-regulation globally – this could mean less financial intermediation globally.
- Demographic change globally: population ageing in AEs and rise of affluent middle class in Asia will mean a shift in consumption demand from AEs to EMEs in general, and within Asia in particular.

What is the upshot? Net exports will no longer contribute as significantly to Asia's growth in the next decade as they have in the past.

To counter a potentially significant decline in overall growth, Asia needs to boost domestic and regional sources of growth.

This calls for policies to encourage greater consumption spending in some countries and more investment spending in others.

In particular, Asia continues to lag in infrastructure capacity and needs to invest significantly more in the years ahead.

Successful rebalancing involves a multi-faceted economic restructuring process that entails macro and micro adjustments:

- Fiscal reforms are crucial. A more developed social safety net can reduce the need for high individual savings.
- Appropriate macroeconomic policies are also important. Real exchange rate appreciation will facilitate expenditure switching towards the non-tradable (domestic) sector.

If appropriately carried out, financial sector reforms can complement and accelerate the process of economic restructuring in Asia by improving the intermediation of savings and raising the efficiency of investment spending.

The deepening of capital markets, in particular, is of critical importance.

The ongoing consolidation by European banks and changes in regulatory and prudential requirements mean that there is an increased need to develop alternative sources of long-term financing to traditional bank loans.

Households will also benefit from financial liberalisation because their savings can be put to better use, thus generating higher returns.

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[4] See for example A Kose, E Prasad, K Rogoff and S-J Wei, "Financial globalisation and economic policies," *Global Economy and Development Working Paper*, no 34, Brookings Institution, 2009. That no significant link was found does not, of course, mean that no such link exists, as the empirical studies are subject to the problem of the bundling of financial opening with a potential host of other growth-friendly reforms, and the endogeneity of the globalisation decision itself.

[5] See the survey in R Levine, "Finance and growth: theory and evidence", in P Aghion and S N Durlauf (eds), *Handbook of Economic Growth*, Elsevier, 2005, pp 866–923.

By fostering financial innovation, liberalisation provides savers with a broader menu of investment and insurance products, thus lessening the motive for precautionary saving.

Jain-Chandra and Chamon argue that improved household access to financial services provides a net boost to consumption. For China, further financial reforms would raise private consumption by about 5% of GDP.

Williamson and Mahar document that the Mexico and Thailand saw an increasing trend in consumption after liberalising their domestic financial sectors in the 1980s and 1990s.[6]

When financial globalisation

Financial globalisation is eventually necessary to maximise the benefits of domestic financial reform but it should not be rushed and it should be carefully sequenced.

In the longer run, greater financial integration and globalisation can potentially yield additional benefits for Asia.

However, certain pre-requisites or “threshold” factors have to be met before a country can be expected to benefit from financial globalisation. Otherwise, the country could experience more crises and lower growth.

Empirical work suggests that only countries with reasonably good public institutions, adequate control of corruption, and a minimum level of human capital seem to be able to translate greater financial openness into higher investment and growth on a sustained basis (Prasad et al, 2003; Kose et al, 2006).[7]

Some empirical papers have reported that greater benefits from financial globalisation were reaped when domestic financial markets were more developed and well supervised. Indeed, domestic financial deepening, along with merchandise trade expansion, makes capital controls more difficult to enforce.[8]

One of the lessons learnt in the Asian financial crisis is that domestic financial reforms should precede financial globalisation.

One suggestion is to first remove controls on long-term capital flows and trade-related flows to facilitate economic growth and development.[9]

Next, controls on short-term flows can be removed after interest rates have been liberalised and government finances put on a sound footing.

Finally, when domestic banks are sufficiently strong and a sound system of banking regulation and supervision is in place, free entry and exit of foreign banks can be allowed.

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[6] J Williamson and M Molly, “A survey of financial liberalization”, *Princeton Essays in International Finance*, no 211, 1998.

[7] M Kose, E Prasad, K Rogoff and S-J Wei, “Financial globalization: a reappraisal and synthesis”, *Journal of Economic Literature*, 2006; E Prasad, K Rogoff, S-J Wei, S-J and M Kose, “Effects of financial globalization on developing countries: some empirical evidence”, *IMF Occasional Paper*, no 220.

[8] M Obstfeld, “International finance and growth in developing countries: what have we learned?”, *Commission on Growth and Development Working Paper Series*, 2009.

[9] F Bernhard and H Reisen, “Towards capital account convertibility”, *OECD Development Centre Policy Briefs*, no 4, OECD Publishing, 1992.

Conclusion

Let me conclude.

Stephen Cecchetti started us off yesterday with the succinct observation that finance and financial globalisation are good, but up to a point.

I think most of us can agree with that – the challenge is in knowing where that point is.

I would suggest that it is not an absolute point – such as a certain credit-to-GDP ratio or capital flows-to-GDP ratio.

That point varies across countries and within countries, across time, closely related to their capacity to cope with downside risks.

The long-term response to the risks of financial globalisation cannot be insulation but rather building up domestic resilience. But some insulation may be necessary while this resilience is being built up.

In this regard, Jacob Frankel's analogy of financial globalisation to driving a car is a good one. The choice is not binary: to drive or not to drive. We must drive, we must globalise.

But to drive, you need a license.

And you must observe speed limits. Driving more slowly gives you more time to react to shocks and lessens the severity of impact when there is an accident.

You must take account of the terrain you are driving on as well as changing weather conditions.

And when the engine overheats, you must pull over and stop.

Thank you.

Remarks by Jose Dario Uribe, Governor of the Bank of the Republic, Colombia

Panel discussion: "Will financial globalisation survive?"

Today I want to address three issues related to the main theme of the future of financial globalisation. First, based on some of the excellent and informative papers presented at this conference, I will offer some thoughts on whether financial globalisation should survive and, if so, what conditions would make it sustainable. Second, based on the Colombian experience, I will discuss some conclusions drawn by Bruno and Shin in their work on the international dimensions of the risk-taking channel. And third, I will touch on some consequences that the current process of deleveraging in advanced markets is having on the financial markets of some emerging economies. From the point of view of the latter, these phenomena are important for they affect the sustainability of the financial integration of our economies into the world economy.

1. Should financial globalisation survive?

In the same way that a deep and well-functioning financial system is useful and desirable for an individual country, financial globalisation is useful for all the benefits that have been widely recognised in the literature and in policy circles.

Nonetheless, as in the case of individual financial systems, financial globalisation entails risks and challenges that derive from three features of financial markets:

- They are prone to suffer from information imperfections and asymmetries that create poor incentives and induce excessive risk-taking.
- Failure of some of their institutions or segments may have systemic and macroeconomic consequences.
- They behave procyclically, propagating and exacerbating macroeconomic shocks.

As pointed out by Taylor, these features give rise to financial crises and to deep and protracted recessions that follow a period of excessive leveraging and risk-taking. And, as argued by Lane, financial globalisation amplifies the scale and the scope of these problems while making their solution more difficult due to their size, complexity, and the need for coordination between different countries.

Hence, if some degree of financial globalisation is desirable, it must be made sustainable by appropriate "global" supervision and macro- and microeconomic regulation in the same fashion that a healthy financial system is sustained in each individual country. This would probably be part of the "first best" solution. However, it is not a practical one in the current state of affairs. As noted by Taylor, not even Europe, with a commitment to a long-term economic and political project, has been able to institute such an arrangement.

Therefore, we must move to the world of the "second best" solutions, in which a more restricted but sustainable financial globalisation is obtained. As the evidence reviewed by Lane suggests, the degree of cross-border financial integration between countries depends on the institutional capacity of each country. Extrapolating this result to the world as a whole, one may say that the world's institutional capacity to deal with financial integration is rather limited.

This applies not only to the world's inability to coordinate adequate crisis resolutions, liquidity or capital regulation and supervision, but it also may be understood in a wider sense as the absence of general macroeconomic policy frameworks that would mitigate the probability of financial imbalances and crises. As noted by Taylor, unlike emerging economies in the past decade, advanced economies generally did not conduct countercyclical fiscal policies or build buffers in good times. Will they in the future? Unlike some emerging economies that were badly hit by previous financial crises, advanced economies did not pay enough attention to credit growth in their monetary and financial policy strategies. Will they from now on?

Thus, as long as neither of these two factors – liquidity provision and crisis prevention/resolution mechanisms – are sufficiently coordinated between countries, and as long as appropriate fiscal/monetary policy frameworks are lacking in relevant advanced and emerging economies, it could be better to proceed on a gradual path of financial globalisation under the following conditions:

- Limited bank and private sector leverage: this would cut credit supply and increase the cost of finance but would reduce the size and contagion of financial market disruptions.
- Stricter FX and local currency liquidity requirements: this is key, especially in the absence of coordinated liquidity provision plans between countries.
- International banks should preferably work as fully incorporated local institutions wherever they are present, subject to the domestic capital and liquidity regulations, and covered by the domestic financial safety net. Again, this could make credit more expensive, but it would limit contagion and rely on supervision and regulation by agencies that are probably more familiar with the local risks and environment.
- Financial innovation should not be discouraged, but new products should carry large capital requirements whenever their risks or valuation are not fully understood by the authorities.
- Large countercyclical capital and provisioning requirements (with respect to the credit cycle) should be embedded as part of the existing rules. This way, an excessive credit expansion is not only more easily curbed, but it is also made less likely since banks can expect that the costs of feeding it will increase.

Elements along these lines are included in the Basel III initiative and are welcome. It will be desirable for them to be shared by many financially relevant economies, so that regulatory arbitrage is limited and the effectiveness of the regulation is not significantly weakened. This would be the minimum of international coordination that is necessary for financial globalisation to be sustainable. Some may argue that this is a return to financial repression. That is one way to put it. Another is that financial globalisation went too far in the first place given the "institutional capacity" of the world as a whole, so it is necessary to step back somewhat.

Yet, although a movement in this direction is clearly a retrenchment of financial liberalisation for a number of advanced countries, for many emerging economies there is still ample room to continue adopting financial products and deepening their financial systems within this more prudent framework.

Finally, a word on financial globalisation and macroeconomic resilience in some emerging economies. The behaviour of some emerging countries in the face of the shocks observed since 2008 illustrate the benefits of flexible exchange rate regimes (among other policy response elements). The shock absorber role played by the exchange rate and the fact that flexible regimes enabled countercyclical monetary policy responses suggest that for many emerging economies, this will continue to be a useful part of their policy framework. But a properly working flexible exchange rate regime requires limits on currency and FX maturity

mismatches, limited financial dollarisation and other related regulation. Hence, from the point of view of these economies, sustainable financial and trade globalisation imply the presence of such restrictions on some financial activities and exposures.

2. On the international dimensions of the risk-taking channel.

In a very interesting paper, Bruno and Shin explore the international dimensions of the risk-taking channel. To be more specific, they studied the influence that monetary policy responses in advanced economies may have on credit supply and risk-taking in emerging economies.

A long period of low interest rates in advanced economies induces cross border lending by international banks and this reduces the cost of funds for emerging countries' banks and their respective customers (firms and households). At the same time, it causes the emerging country's currency to appreciate. The latter effect increases the net worth of the emerging country residents, thereby reducing their perceived risk and opening additional room for more cross-border lending. Moreover, the new capital flows stabilise the exchange rate and further enhance the scope for cross-border lending. The trouble is that these cycles feed excessive risk-taking in the emerging economy and exacerbate the build-up in both credit and spending. This makes the reversal of the external conditions traumatic.

This is a relevant channel of transmission and poses a serious challenge to monetary policymakers in emerging economies. The case of Colombia may be of interest for evaluating policy responses to this phenomenon. Our position is rather fortunate because we have a substantial non-tradable sector and we are net commodity exporters. This means first, that the pass-through from the exchange rate to domestic prices is low, and second, that large capital inflows tend to coincide with external conditions that enhance national income and aggregate demand. Hence, policy interest rates have been generally raised during periods of large capital inflows, thus reducing the impact of the risk-taking channel.

In addition, the policy framework itself has features that dampen the effects of this channel. To begin with, the flexible exchange rate regime and an increasingly credible inflation target have further weakened the pass-through. The downward pressure on policy rates stemming from the appreciation of the currency has thereby been reduced. Second, exchange rate flexibility also discourages the emergence of currency mismatches (due to the greater volatility of the exchange rate) and reduces the incentives of local borrowers to use cross-border, dollar-denominated funds. Third, we have strict regulation preventing financial dollarisation and restricting currency and FX maturity mismatches by banks. In practice, this means that all cross-border financing must be provided internally in the same currency and with terms that are no longer than those of the original foreign funds.

Thus, the scope for a substantial expansion of local credit following a reduction in external interest rates is rather limited. Intermediated cross-border flows are low relative to the total credit supply. However, in some instances it is possible that the collateral valuation effects could be too strong, or currency mismatches in the real sector might rise significantly, or overall real sector leverage increase too fast, or the appreciation pressures could become strong enough to keep policy rates too low for too long. In these cases, we are willing to use and have used temporary capital controls in the form of unremunerated reserve requirements on external loans. These are also sometimes coupled with the imposition of temporary marginal reserve requirements on domestic deposits.

Is this policy response to the risk-taking channel easily applied in other emerging countries? Probably not, especially in more open economies, where the pass-through is larger and the possibility of raising policy interest rates in the face of declining external interest rates is more restricted. In these cases, conflicts between price and financial stability may be more

common and could require more frequent deviations from the inflation target (with the corresponding communication effort) or more frequent use of capital controls.

3. On some implications of advanced economy deleveraging for emerging countries.

As part of their deleveraging process, financial institutions in advanced economies are selling a number of assets and businesses they hold in emerging countries. The buyers in many cases have been financial institutions from emerging economies.

This poses a risk and a challenge for financial regulators and supervisors in the emerging world. For example, Colombian conglomerates are now in control of several banking and pension businesses across Latin America. Our regulation and monitoring plans were designed to deal with an arrangement in which foreigners owned part of the local financial system, not the other way around.

Critical questions emerge. Do we have adequate and timely information on the credit, liquidity and market risks of Colombian banks abroad? Do we understand the regulatory frameworks and financial safety nets in the host countries? Can we assess the consolidated currency mismatches of the Colombian conglomerates, including the exposures of their branches abroad? There are many other questions.

This is an issue that must be closely monitored since the ownership of many financial institutions across the emerging world may now be in the hands of agents whose home regulatory and supervisory agencies may not have sufficient expertise or resources to deal with systemic problems at the regional level (as opposed to the national level).

Of course, this is relevant to both the host and home countries. For the host countries, it is key to gauge the risk control, liquidity/capital provision facilities, and resolution mechanisms of important parts of their financial systems. For home countries, it is crucial to assess the vulnerability of their financial system and the fiscal, exchange rate, and monetary implications of this new exposure. For both, it is a contagion channel that must be understood and monitored.

In short, some of the hazards of financial globalisation discussed at this conference may now be transferred from advanced economies to other parts of the world, whose "institutional capacity" may be even lower than that of the developed world.