Christian Noyer: The challenges of financial liberalisation for emerging market economies

Speech by Mr Christian Noyer, Governor of the Bank of France, to RBI staff, Reserve Bank of India, Central Office, Mumbai, 14 May 2007.

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I am very pleased and honoured to be here and I want to thank warmly my good friend, Dr Reddy, for having invited me to address the staff of the Reserve Bank of India (RBI).

The BIS recently announced that the RBI Vice-Governor, Mr Rakesh Mohan, will chair a new working group on "Capital flows and emerging economies". I would like to congratulate him for accepting to explore this complex issue. I will offer some views on a related topic: "the challenges of financial liberalisation for Emerging Market Economies (EMEs)".

Financial liberalisation is defined here as the dismantling of internal and external controls on capital flows. It exhibits many positive aspects, for instance:

- it contributes to improving global capital allocation efficiency, be it at the national or at the international level;
- it fosters competition on capital markets and consequently reduces the cost of capital as well as it brings about enhanced risk management;
- it also increases the role of market discipline for firm managers and policy makers since it raises the costs of poor governance.

While there is a consensus about these positive effects, experience has shown that financial openness modifies the balance of risks at the macroeconomic level:

- first, it may reduce some risks, for instance, by decreasing the correlation between investment and savings;
- second, it may nevertheless increase other risks: for instance, greater competition in the banking system may prompt strong credit growth with a loosening of credit standards, as domestic banks try to maintain their profits and market shares;
- third, it may even create new risks, for instance through financial contagion, if risk appetite for emerging markets suddenly reverses, given the prominent role played by hedge funds in cross-border investments and the sudden shifts in their asset allocations. In this regard, the Banque de France recently published a special issue of its Financial Stability Review devoted to Hedge Funds, which may be of interest to the RBI (www.banque-france.fr).

In contrast with the French experience which took place in the 1980s, the Indian process of financial liberalisation takes place in a context of intense globalisation and accelerated innovation. It is gradual but successful and it is no surprise that India was one of the first countries to participate voluntarily in the IMF Financial Stability Assessment Program (FSAP). In my view, the progressive and transparent character of this process is fundamental to guarantee that a country reaps the full benefits of its integration into the world economy.

The lessons that can be drawn from a comparison with the French experience may seem limited since, in the 1980s, France was facing capital outflows, whereas emerging economies are now often facing speculative capital inflows. However, I believe that, while the challenge has become more demanding, successful financial liberalisation for EMEs still rests on the same two key conditions that applied to France:

- Building a resilient domestic financial system while or before opening the capital account.
- Shaping appropriate institutions and policies.

I will illustrate these two conditions in the reminder of my speech.

1. A successful liberalisation requires to strengthen the domestic financial system while, or sometimes before, opening the capital account

I will briefly remind you why and how this can be done.

First, why? This is because an efficient financial sector ensures both a better financing of and a better protection for the economy.

On the one hand, it ensures a better financing of the economy by broadening the investor base and enhancing their ability to make use of diversified financial instruments.

Not only does competition within the financial sector contribute to limiting the cost of capital but it also fosters innovation and thus allows for more efficient risk management. For example, securitisation provides financial institutions with instruments to manage the composition of their balance sheets and thus contributes to buttressing credit distribution while supporting the development of financial markets. Moreover the development of bond markets allows for a better financing of public deficits while providing instruments that enable international investors to diversify their portfolios. It provides a reference for the market and may thus pave the way for the issuance of private bonds.

On the other hand, an efficient and developed financial sector offers better protection for the economy against the risks of a capital account crisis. Most of the EMEs' crises of the 1990s were triggered or accompanied by banking crises. To improve resilience to external shocks, it is essential that financial players be able to manage interest and exchange rate risks in a more flexible environment, both for themselves and their customers.

Now, how to achieve this in a smooth way?

There is a kind of paradox in the interaction between internal and external liberalisation: the former may be a pre-requisite for the latter but external openness may help stimulate and enhance domestic financial reforms. Actually, in the absence of the challenge created by foreign competition, domestic financial reforms may not be broad and fast enough.

Moreover, in terms of best practices dissemination, the presence of foreigners in the capital of domestic banks may ensure a faster adoption of international standards and codes, especially concerning the monitoring, control and management of financial and operational risks. This is crucial for the resilience and the stability of the financial system. The report of the CGFS Working Group on "FDI in the financial sector of EMEs" highlighted that a lasting benefit of these FDI was their effects on the financial sector efficiency, thanks to the generally associated technology transfers and innovations in products and processes. In addition to their lower volatility, this is one more reason why attracting long-term capital flows, such as FDIs, seems preferable to catching short-term flows, although the lessons from the Chilean experience versus some Asian misadventures suggest there is no unique model for all. But I saw that the size of FDIs in India which had been hitherto rather low is rising significantly (16 billions USD in 2006-07) which is good sign of its attractiveness. In France also we pay a lot of attention to inflows of FDIs (above 60 billions in 2006) as they matter as well in a more mature economy.

So when setting the pace of internal versus external liberalisation, the authorities have to strike the right balance and rhythm between the two sides. In this respect, let me evoke briefly the way we managed this process in France in the 1980s. Financial liberalisation started with the domestic side by:

- Modernising the money market;
- Deepening the bond markets, using the public sector as a benchmark (in order to price risks through a full yield curve for risk-free assets);
- Broadening the basis of the equity markets (including privatisations);
- Last but not least, creating new financial markets (futures, options…).

Meanwhile, but sometimes with lags, the French capital account was liberalised. We switched from a situation, in 1983, where the exchange rate controls were at their tightest, following speculative attacks and three devaluations in 18 months, to a gradual removal of these controls beginning in 1984 and completed in 1990. Trade-related operations were gradually liberalised, followed by most financial transactions and, finally, residents were allowed to freely open foreign currency accounts and French banks to lend French francs to non–residents.

Of course, the Indian experience differs from the French one as there is no "one-size-fits-all" transition process. And I would be very interested in listening to your views on this.

2. But before, let me remind you that, to be successful, it is not sufficient to improve the financial system: shaping appropriate institutions and economic policies is of the essence

The need to set in place strong institutions should never be underestimated. A G20 work entitled "Institution building in the financial sector" (in which both India and France participated) stressed the importance of solid institutions along with deep and sophisticated financial markets as key elements to maximise the benefits of globalisation and reduce the risks of financial crises. An appropriate institutional framework includes among others a well functioning legal system, a reliable payment system, a proper framework for regulation and supervision, an appropriate deposit insurance scheme, and propitious conditions for implementing new developments in information and communication technology.

As a central banker, I will of course argue that the role of the central Bank is crucial. It should be the guardian of the health of the "financial ecosystem" through reinforced surveillance and a continuous improvement of the regulatory and legal framework. Sound supervision must be promoted by an independent body, which may be more or less related to the central bank. In France as in India, banking supervision is indeed implemented by the central bank staff. Sound supervision and a clear legal framework in turn are likely to encourage foreign participation and maximise the associated benefits in terms of best practices.

The need for appropriate supervision is indeed not reduced but modified or may even be increased in case of financial liberalisation. For instance, a working group in process at the BIS, in which both the RBI and the BDF are currently participating, shows that the development of local bond markets changes the types of risks faced domestically from currency risks to interest rate risks or maturity mismatches. This requires to enhance and control adequate risk management in the banking sector and in those institutions in which the risk may have been transferred. Indeed financial innovations such as credit risk transfers may well spread risks but risk does not disappear.

The central bank is also responsible for producing and disseminating various sets of monetary and financial statistics whose quality is of utmost importance for policy makers and investors. An efficient statistical apparatus provides the basis for financial transparency, thus contributing to disseminating best practices in terms of governance.

Besides, institutional quality also strongly influences the composition of inflows into emerging economies. This is a key determinant of FDI flows, which tend to increase the benefits of financial integration.

The need for sound economic policies and strategies should not either be neglected.

In a globalised world where countries compete to attract foreign capital, sound fiscal and monetary policies influence not only the amount but the composition of inflows. Sound domestic policies strengthen the resilience of the economy to external shocks and thus maximise the growth benefits of capital account liberalisation.

Recent crises remind us how macroeconomic imbalances may be exacerbated by financial fragilities and trigger capital account problems affecting economic growth. For instance, experience shows that excessive fiscal deficits are more dangerous with open capital markets. Actually, market discipline is not always at play or sufficient if there is excessive appetite for risk and not enough discrimination. Therefore, internal rules as well as Government commitments may be needed as illustrated by the so-called European Stability and Growth Pact.

In the same way, structural policies aiming at improving the efficiency of the labour and good markets shall accompany financial liberalisation. They are indeed needed to enhance the capacity of the real economy to attract and allocate capital as well as to reduce vulnerabilities and absorb potential shocks. Here again, there is a nexus in the appropriate rhythm and interaction between the liberalisation of financial versus real markets. Once financial liberalisation has started, the process benefits from continuous innovation and from its own impetus. The same does not apply to reforms in the labour and good markets where rigidities and obstacles are often deeply rooted.

Lastly, better integration into the global economy requires an appropriate exchange rate strategy. An emerging economy with high productivity gains and potential growth in the tradable sector is prone to receive large capital inflows and have a real appreciation of its currency in the long term. The latter may come either or both from nominal appreciation or higher relative inflation.

Arguably, exchange rate appreciation, which may result in an overvalued currency, is a risk for emerging economies that conduct export-led growth strategies. In order to stem appreciation and maintain their competitiveness, some emerging economies – like China – have accumulated ever larger amounts of foreign reserves. However, undervalued currencies also represent a significant risk, not only for inflation but also because it allows foreigners to buy cheaply national assets. In addition, undervalued currencies contribute to ballooning global imbalances. "En passant", I am pleased to note that both India and the Euro area post significant but not extravagant levels of reserves and that neither is responsible for the persistence of global imbalances.

Greater use of exchange rate flexibility in emerging countries that have experienced an excessive accumulation of foreign exchange reserves is therefore one factor in the resolution of global imbalances. Moreover, it may contribute to facilitating domestic monetary policy management (decreasing inflationary pressures) and makes it possible to better contain liquidity growth and the risks associated with reserve accumulation and sterilisation.

Of course, the gradual implementation of exchange rate flexibility requires that controls on capital flows be lifted at a suitable pace. East Asia experienced this and I am eager to listen to your views on the interaction between financial reforms, institutions and structural or macro-economic policies.

To conclude, let me say that, in the liberalisation process in which France and later India have engaged, both may learn from each other since they share similar features and are key players in a globalised world.

To this end, cooperation should be strengthened.

Cooperation between the RBI and the Banque de France is especially relevant since our two institutions look alike, for instance in terms of diversity in activities, structures (including branches) or staff recruitment for life through competitive examinations.

At the financial industry level, more cross-fertilisation should also help. The French financial industry includes some of the largest European banks and insurance companies. Their business models are solid and based on a broad domestic market and best international practices. This enables them to generate strong profitability and develop abroad.

But above all, the French financial industry has some specific features that may be valuable for Indian players. In particular, I would like to mention:

- The historical links with the public sector, such as in India where public banks still dominate the banking sector and
- Banking sector expertise both in a rural environment, especially relevant for India, and in large industrial groups, as indeed Indian industrial groups are active internationally.

In this respect, I am very pleased to participate with the RBI in the launching of the first French-Indian Financial Forum on May 16, in Mumbai.

Thank you for your attention.