Christian Noyer: Globalisation of capital markets

Speech by Mr Christian Noyer, Governor of the Bank of France, at Paris Europlace, International Financial Forum, Tokyo, 27 November 2007.

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Ladies and gentlemen,

It is a great honour and a pleasure for me to speak before such a distinguished audience and I am delighted to be in Tokyo today. In the last decades, global economic growth, financial innovation and financial globalisation have progressed hand in hand. This does not exclude, of course, challenging episodes of stress, such as the current one.

Financial globalisation is not a new phenomenon, but the scale and speed of the current phase of globalisation is unprecedented; cross-border and cross-market links are deeper than ever before. Events are still unfolding, but the dynamics of the current crisis has been a live experiment of how globalisation has modified the reaction of the financial system to shocks. The magnitude of possible losses is, in many respects, contained. Current estimates put the direct cost of subprime defaults at around 250 billions USD. It is significant but bearable, especially starting from a point of very favourable economic conditions and high profitability.

Still, what began as a sound correction of the undervaluation of risks in the subprime market unravels as one of the major financial crisis of the past 10 years. Some scenarios considered as very remote crystallised on a large scale, while widely expected break-up points held up well. Hedge funds, once considered as a source of systemic risk, fared better than regulated institutions. The inter-bank market, traditionally the most liquid and efficient of all markets, has experienced serious dislocation, while equity markets were relatively unscathed. The spreading of defiant expectations from the subprime US market to other segments, other institutions and other regions has been unexpected, asymmetric and disconnected from the magnitude of the initial shock. It invites us to revisit our reading of globalisation and contagion in the light of current events.

The ongoing financial globalisation is underpinned by three main drivers, each of them **strengthening the two others**.

The first driver, and probably the strongest, is financial innovation. Supported by technological progress, financial innovation has fostered the emergence of new financial products and services, resulting in more complete financial markets. Thanks to advances in financial technology, it is now possible to break up the risk of an asset into its constituent parts and to recombine them as wished, to fit a specific investor's risk profile. The emergence of derivatives, combined with the appropriate mathematical tools to price them, has greatly expanded the range of tradable risks, opening up new and vast horizons for hedging strategies. Financial institutions are able to actively manage their exposures and reallocate certain risks to those players that are most able to bear them. Overall, investors are more willing to invest across borders, knowing that they can reach an improved risk-return trade-off.

Simultaneously, economies are becoming more open financially, especially in the emerging world. The growth of international capital flows is the consequence both of domestic policies and global factors. Domestically, financial liberalisation and deregulation have relaxed investment restrictions. More flexible exchange rate policies, liberalisation of capital accounts, the opening of domestic stock markets to foreign investors as well as "investor-friendly" policies help to attract foreign investors. Global factors have also played a role, with the abundant global liquidity environment as well as the decrease in home bias. By way of example, non-residents currently hold 46% of French market capitalisation and slightly more than 50% of French government bonds.

A third driver is the emergence of global financial players, such as large banks, hedge funds, private equity funds and more recently sovereign wealth funds. They all share common characteristics:

- They play an important role in fostering market efficiency, and provide liquidity to capital markets;
- They use sophisticated investment strategies;
- They implement advanced risk management practices, and help to spread them across markets and countries.

However, because of their sheer size and potential impact on market equilibria, they raise some concerns of transparency as well as questions about their role in fostering, or not, financial stability.

Those issues warrant being debated.

What are the consequences of the financial globalisation currently underway for global capital markets? They are well known, so I will just highlight two of them.

***First,* globalisation increases the efficiency of financial markets.**

Thanks to financial globalisation and technological progress, *informational* efficiency of capital markets has increased over the past few decades. Any new available information is accurately processed and impounded in asset prices, leading to more accurate pricing of assets and risks. And the permanent quest for arbitrage opportunities has fostered cross-market and cross-border strategies also leading to more consistent pricing.

Allocative efficiency, that is the market's ability to allocate resources in a way that maximises the welfare attained through their use, has also improved: for a given investor, there is a wider and more diversified range of investment opportunities than ever before.

Operational efficiency has so far gained from globalisation, since the cost of financial operations has quickly fallen, due to productivity gains in the financial sector stemming from the scale and scope of economies and the intense competition between markets and intermediaries.

Nevertheless, this overall trend towards efficiency occasionally bumps into puzzles that are not readily explained by economic theory. For instance, the longstanding question as to why capital does not flow, in net terms, from rich to poor countries has not yet been clarified since it was first addressed by Robert Lucas. It has recently been supplemented by the so-called "allocation puzzle", highlighting the fact that capital seems to flow toward economies with relatively low investment rates. Convincing explanations for these puzzles certainly require taking into account market imperfections (such as credit constraints), differences in financial infrastructures as well as growth externalities (such as human capital).

Another salient feature of financial globalisation is the rapid maturing of emerging economies and markets. In 2007 and 2008, the IMF expects emerging countries to account for more than half of world economic growth. The same positive trend is reflected in their financing conditions. Emerging market economies increasingly finance themselves in the form of bonds in local currency at long maturities and fixed interest rates. By doing so, they have escaped the curse of "original sin" – the inability to borrow abroad in their own currencies – that made the crises of the 1990s so costly. Their capital markets have expanded rapidly, both in size and in the range of instruments available. Asian stock market capitalisation, for instance, increased five-fold between 2000 and 2005, as against only a one and a half times increase for the major European and US stock exchanges. Issuance of bonds and syndicated loans from emerging market corporates has also accelerated markedly, and has even exceeded sovereign issuance in some countries. Lastly, risk premia on emerging market assets have fallen significantly, reflecting sound economic fundamentals. For this series of reasons, emerging markets have become an attractive asset class for long-term international investors, as shown by their rising share in asset allocations. It is therefore not so surprising that they have so far been relatively immune to the current subprime crisis, and might even be seen as “safe havens”!

Let me now turn to some major challenges of financial globalisation.

***First*, the impact on monetary policy.** Some analysts have suggested that, because of capital market integration, real interest rates will equalize around the world, thus reducing the ability of national Central Banks to control inflation. However, this need not be the case. Indeed, the classic Mundell-Fleming analysis concludes that monetary policy should be more effective, rather than less, in the case of international capital mobility, although it can operate through different channels of transmission including the exchange rate. Furthermore, in many emerging countries, strong capital inflows confront monetary policy with a dilemma between pursuing internal and external objectives, in a context of rising inflationary pressures. Taming capital inflows would call for a relaxation of monetary policy, at the risk however of compromising on the domestic objective of maintaining low inflation. Sterilisation cannot always be relied upon to resolve this dilemma as it is likely to be ineffective in the long term and fuel other imbalances such as excessive accumulation of foreign exchange reserves.

***A second question* is the potential for global contagion.** As a direct consequence of cross-border financial integration, local price or liquidity shocks are more likely to spread around the globe. Large-scale liquidity creation resulting from monetary (or exchange rate) policy in one country may fuel asset price bubbles elsewhere. One current example might be seen in carry trades, which have become a major driver of a number of currencies, including the yen. Therefore, distant events can have sharp impacts, even on local institutions or investors. New contagion channels have emerged. With more risk traded in and through markets, the potential knock-on effects from an erosion of liquidity in some segments or for some institutions have multiplied, and we are currently experiencing how unexpected this process can be. Risks have become “mobile”, if I may put it like that, so mobile that we lose sight of their true location.

***The third and final set of issues* relates to global imbalances.** The facilitation of cross-border capital flows may have relaxed financing constraints for borrowers, making it possible to finance ever larger current account deficits. In one sense, the contribution of financial globalisation to disconnecting national savings and national investment is a welcome development, to the extent that it allows for a more efficient global allocation of savings. However the differences in the development of financial markets around the world may also have created, or at least facilitated, global imbalances. The ability of countries to produce sound and liquid financial assets is largely disconnected from their level of economic growth : rising revenues in the emerging world need to “find a home” in sound and liquid financial markets.

Finally, in any case, the question of sustainability – the resilience of capital flows to the accumulation of imbalances – remains a pressing one. While capital flows tend to move freely across borders, exchange rate regimes remain very diverse in their degrees of flexibility. This leads to asymmetric adjustments depending on the exchange rate regime, not only between currency areas, but also inside the same region, such as in Asia. Overall, some of the main floating currencies may end up bearing a higher share of the adjustment on their shoulders than they should. Maintaining integrated global capital markets in an environment where such differences persist might not be sustainable over the long term. An orderly unwinding of global imbalances might therefore imply greater flexibility from countries with large current account surpluses and fixed exchange rates.

I will conclude on a matter of debate for international financial stability for the future. As I have said, financial systems have become more efficient as a result of globalisation and innovation. But have they become more resilient, that is, more capable of absorbing shocks? None of us has the answer to that question now, but it will be interesting for central banks and regulators to monitor financial developments in the coming months, in search of clues. Ladies and gentlemen, thank you for your attention.