Christian Noyer: International financial stability

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the Lloyd's City Dinner, London, 29 September 2010.

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Although the financial crisis originated in one country, it quickly became apparent that it was truly global in nature, both in terms of its mechanisms and its consequences. It brought home a simple message: capital markets are closely interlinked around the world and, thus, domestic and international financial stability cannot be dissociated.

Today, I would like to reflect upon international financial stability: what it means, whether or not it should be pursued as a major policy objective; and finally, what actions should be taken and which instruments should be employed. The views expressed are my own and do not represent an official position. However, as you know, next year France will hold the Presidency of the G20 and, bearing this in mind, I will try and offer my own thoughts.

International financial stability: what does it mean?

Over the last decades increased financial integration has led to greater reallocation of savings across countries. The expansion of gross and net capital flows has been spectacular. As a result current account imbalances have increased both in amplitude and durability. In fact, they have become a permanent feature of our economic environment. Many analysts would argue that these imbalances are the ultimate cause of the crisis. I would not go that far. But it seems reasonable to assume that some common causes lay behind both the crisis and the imbalances themselves.

International capital flows have made countries increasingly interconnected and interdependent. At the same time, major transformations have occurred over the past decade in our international environment. The monetary and financial system has become truly "multipolar". An increasing number of countries, both developed and emerging, have become active participants in the global capital market. While there are currently three main currency blocs, at least one (the Chinese RMB) and maybe other additional systemic currencies will emerge in the future.

Participants in the international financial system are increasingly diverse from the point of view of their economic structure, their demography, their level of development, and, more importantly, their social choices and preferences. For instance, different saving rates may be seen as resulting from divergent time preferences. Likewise, diversity in capital account regimes may, to some extent, reflect different choices and tradeoffs between efficiency and stability in the financial infrastructure.

These characteristics will most likely persist over time. A large number of different countries, with different preferences, will permanently be linked and interdependent through growing and active international capital markets.

It is not clear, at this stage, how the coexistence and interaction between national financial systems worldwide will finally play out. Looking beyond short-term volatility, the real question is whether this architecture will be conducive to the efficient and stable allocation of capital over the long run; or whether, on the contrary, it will lead to an accumulation of imbalances and recurrent bouts of instability.

An optimistic view can be found in the "Bretton Woods II" theory, which posits that the pattern of international capital flows results from a mutually beneficial equilibrium between two groups of countries. On the one hand, emerging economies follow an export-led development strategy and seek to prevent appreciation of their real exchange rates by constant foreign exchange intervention (together with capital controls). As a consequence, they accept to accumulate increasing stocks of liquid assets denominated in dollars. On the other hand, the United States is happy to receive both reserve inflows to finance its deficits and cheap imports to fuel their demand for consumption goods. Such equilibrium is stable by virtue of the mutual benefits it brings to both groups. Moreover, the longer it lasts, the more impossible it is to change since both groups become mutually dependant through the stock of claims and debts they have reciprocally accumulated. This “financial balance of terror” is supposed to keep the system in place for a long period of time.

A more recent, and pessimistic, explanation is provided by the “asset shortage” theory according to which the world has a shortage of liquid and riskless assets. Moreover, the supply of these assets is asymmetrically distributed between regions, with the US providing a large chunk of the total. Hence, there is a structural excess demand for dollar-denominated securities, which sustains permanent capital inflows from emerging economies into the United States.

This approach has deep implications.

It shows why, for more than a decade now, capital has been continuously flowing “uphill”, i.e. from poor to rich countries, with current account surpluses in emerging economies reflected in growing deficits in the United States.

It also helps to explain why asymmetries in financial development between countries generate both payment imbalances and asset bubbles. To the extent that the US financial system did not generate enough “pure” safe assets, this created an incentive for the financial sector to manufacture such assets through the securitization of lower quality loans, but at the cost of greatly increased (if hidden) financial fragility. This fragility became apparent when the whole architecture of securitization collapsed under the weight of excessive leverage and maturity transformation.

The point here is that internal and external financial stability are two sides of the same coin. Domestic financial imperfections, on the one hand and distortions in international capital flows, on the other, interact with each other to create and amplify imbalances. Ultimately, financial instability is a product of this through this interaction. International financial linkages therefore can be a source of increased fragility for many national economies, including the largest ones.

International financial stability: does it matter?

International financial instability manifests itself through various channels. Assessing its impact is difficult. Opinions may differ as to whether volatility in capital flows and exchange rates is excessive or, rather, a pure reflection of variations in fundamentals. By the same token, movements in asset or commodity prices can be seen to reflect the balance of supply and demand forces, or, alternatively, to be the product of speculative activity.

Looking at the behaviour of most countries during the crisis, however, it is very apparent that they felt threatened by the instability of capital flows and, accordingly, sought to protect themselves from its consequences.

The provision of international liquidity, in particular, has been severely disrupted during the crisis. Emerging (and some industrialised) countries have suffered from acute dollar liquidity shortages which had to be remedied, inter alia, through a network of currency swaps between central banks. The crisis is a powerful reminder that liquidity – both domestic and international - can never be taken for granted. In today’s world, most international liquidity is privately provided and represented by claims on private institutions. Interbank markets play a crucial role in this process. The more capital markets become integrated at the short end, the more international liquidity is provided by the private sector.

The importance of global private liquidity conditions was apparent in the period which followed Lehman's failure. Output and trade fell across the world with astonishing simultaneity. It seemed natural to assume, at the time, that "traditional" forms of contagion – through goods or capital markets – were at work. Policy makers were looking to trade finance as a major channel. However, contagion takes time and cannot fully account for the exceptional synchronisation in the drop in output. With hindsight, the phenomenon may best be seen as a global liquidity shock. Net supply of liquidity dried up at the same time everywhere in the world. International banks faced a sudden and ample shortage of dollars. Firms started to hoard liquidity. Investment and, in part, production, came abruptly to a halt.

When such a shock occurs, public provision of liquidity has to replace private provision. In a domestic context, this is the function of the lender of last resort. But when there is a shortage of foreign currency liquidity, this role has to be played by foreign exchange reserves.

Following the 1997–98 crisis, emerging countries constantly sought to expand their foreign exchange reserves. The average reserve ratio of emerging markets has more than quintupled from 4 percent to over 20 percent of GDP since 1990. One cannot assume, however, that equilibrium has been reached and that the demand for reserves will stabilise. On the contrary, there are strong indications that this trend will persist, or even be amplified, following the crisis.

This may be seen as undesirable but also unavoidable in the current financial architecture. No amount of reserves will fully protect a financially open economy against a systemic shock. It is notable that countries, such as Korea, which had very significant amounts of reserves prior to the crisis and a flexible exchange rate regime, nevertheless felt the need to enter into currency swaps with the Federal Reserve.

During the crisis, foreign exchange reserves were used as a tool for *internal* – as well as external – financial stability. National central banks, especially in Latin America, acted as dollar lenders of last resort to their domestic banks. This function will develop in the future and is bound to impact the demand for reserves. Financial openness and integration means that domestic banks will engage increasingly in foreign currency operations. In turn, the expansion of international balance sheets will increase the potential demand for liquidity support in the event of shocks. This trend should be accepted as a normal consequence of open capital markets and international banking, together with the predominance of a very limited number of currencies in international finance.

One general lesson can be drawn from that experience. In the current environment, there is an inescapable trade-off between financial openness, on the one hand, and the need for protection against external financial volatility, on the other. An essential question for the future is whether we can improve this trade-off and avoid the costs and distortions associated with growing amounts of foreign exchange reserves and/or further restrictions on international capital mobility.

International financial stability: what should be done?

Looking at the next decade, a number of different developments in the international financial system are possible.

Capital markets could go through a process of progressive and partial fragmentation: no significant capital account opening would occur in many parts of the world. Conversely, new barriers could be erected either in the form of "soft" capital controls or through national regulations forcing financial institutions to ring-fence local pools of capital and liquidity. There would be little convergence in domestic financial systems and regulations. Foreign exchange reserves would keep growing, both in absolute terms and as a percentage of world GDP.

This scenario may be seen as the only realistic response to increased diversity in a multipolar world. The systemic consequences, however, are not clear. In such a world, current account imbalances would be heavily influenced by public actions and policies. Regulatory competition would determine the location of financial activities and the allocation of savings. In the absence of some “rules of the game”, tensions would naturally arise between countries regarding many aspects of their domestic and international macroeconomic policies.

The opposite scenario would involve the progressive opening of all capital accounts, together with some (more or less intensive) convergence in financial systems and regulations. This would allow for the emergence of a unified world capital market, an efficient allocation of savings across countries and a smooth financing of current account imbalances. Experience shows, however, that an open international financial system is not inherently stable and, therefore, very dependent on strong infrastructure.

Two elements of such an infrastructure seem especially important.

First, countries could come to a common understanding about the core elements and principles governing their financial markets development and regulations. Full harmonisation is neither desirable nor feasible. But policy-induced divergences may prove very destabilising and lead to a reduction in welfare. It should be possible to agree on the core principles governing, for instance, capital account regimes, the treatment and resolution of internationally-active financial institutions, deposit insurance, and the organization and functioning of securities markets. Divergences in financial development are a fact of life. Some of them reflect true social choices and preferences that must be respected and accommodated. Others result from deliberate or inadvertent policy-induced distortions, which should have been reduced or eliminated. Disentangling these two sources of divergences in financial development should be a priority in the international agenda.

Second, the search for an efficient and powerful “financial safety net” should be pursued. Stabilising the demand for international reserves would bring huge benefits in terms of world welfare. At present, reserve accumulation can only occur through a conjunction of balance of payment surplus and some degree of exchange rate intervention. In addition, if sterilisation proves difficult or impossible, it also leads to unwanted changes in monetary policy. Precautionary reserve accumulation, however legitimate, unavoidably creates side effects for domestic macro policies as well as spillover effects on other countries. All countries, therefore have a common interest in finding ways to disconnect reserve accumulation from exchange rate management and, more generally, from balance of payment situations and monetary policies.

The difficulties, however, are huge. The search for new liquidity sources through, for instance, multilateral mechanisms, meets with an inevitable moral hazard problem. First, to be equivalent to reserves going forward, multilateral liquidity must be available ex ante and without condition. Second, there is a danger that fully unconditional liquidity be used to deal with fundamental “solvency” imbalances. A delicate balance will have to be struck, either within the framework of current IMF facilities, or by setting up new and innovative mechanisms.

Let me now conclude. I am aware that I have raised more questions than provided answers. I also know that many of the issues I have mentioned are hotly debated and, often quite contentious. This is normal. No one can claim to fully understand the dynamics of the new financial world we shall be facing in the coming decades. We also know that, after a crisis of this magnitude, “business as usual” is not an option. The last three years have shown how much countries are mutually dependant on each other. There would be no excuse for inaction and there are, on the contrary, many opportunities for cooperating and building together a better and safer international financial system.

Thank you.