Christian Noyer: International financial stability

Keynote address 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 International Paris-Europlace Financial Forum, Tokyo, 29 November 2010.

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Although the financial crisis originated in one country, it quickly became apparent that it was truly global in nature. It brought home a simple message: capital markets are closely interlinked around the world and, thus, domestic and international financial stability cannot be dissociated. They really are two sides of the same coin.

Today, I would like to reflect upon international financial stability. The views expressed are my own but, as you know, France now holds the Presidency of the G20 and I will try to put my own thoughts in that perspective.

International financial instability has increased over the last period. Whether we look at exchange rates, international capital flows or commodity prices, signs abound of more intense volatility.

Volatility may not necessarily be a bad thing. To some extent, it is a sign of well functioning financial markets. Movements in asset prices help the financial system to serve as a cushion, an “absorber” for exogenous economic shocks. This is welfare improving since it avoids, or mitigates, adjustment in more rigid goods or labor markets.

Volatility may also be driven by fundamentals. For instance, capital inflows to emerging economies partly reflect very favorable long term growth prospects and high potential returns on capital. This can’t be seen as an anomaly. If anything, it remains counterintuitive that *net* capital flows are still going “uphill” from emerging to developed economies. That means that some of the poorest citizens of the world are lending money to some of the richest, allowing those to finance their consumption.

The same holds true for commodities prices. Commodities markets increasingly function like asset markets with the development of financial instruments based on commodities baskets. In fact, commodities have become an asset class in themselves which warrants special attention in terms of financial stability. On the other hand, there may be good reasons to think that “fundamentals”, such as strong growth in commodity intensive emerging economies countries underpin the current behavior of many commodity markets.

Finally, financial volatility may be the product of some very specific features of the current environment. The conjunction of economic uncertainty, high risk aversion and ample liquidity worldwide is especially conducive to abrupt shifts in sentiment and portfolio allocations.

Volatility becomes a problem when it is policy induced and, therefore, financial markets contribute to aggravating shocks instead of attenuating them. Then, durable instability settles in and creates potential threats for the real economy. We may be in such a situation today as there are doubts about the mutual consistency in economic strategies pursued by major economies. At the same time, some of the policies implemented to deal with volatility may cause additional damages and distortions in capital markets. I will address those two issues before turning briefly to longer term challenges.

Global imbalances and financial stability

There is broad agreement on the need to rebalance aggregate demand across the world. That shared objective has underpinned the cohesion exhibited by G20 countries during the acute phase of the crisis. It has played an essential role in 2008 and 2009 in restoring confidence and setting the path for the recovery. However, this concerted approach to global imbalances may have weakened recently. There is clearly a debate going on about two major and interrelated issues: first, the appropriate pace of the rebalancing, with advanced countries feeling a greater sense of urgency; and second, on the most efficient strategies, in particular regarding exchange rates.

It would a mistake to ascribe responsibility for imbalances to one specific cause. All countries have legitimate concerns. We have seen in recent weeks a tendency by countries to challenge each other monetary policy. This cannot produce a good outcome.

We have to start from three basic realities.

First, countries are free to conduct monetary policies they deemed appropriate. Indeed, when Central Banks are independent, they are legally obliged to do so. Monetary policies are conducted with domestic objectives in mind but, as you have noticed, all central banks have the same mandate: to maintain price stability. This is true for all countries, whether small or large. The world has enormously benefited from two decades of price stability resulting from monetary regimes based on Central bank independence and a focus on internal price stability.

Second, according to the IMF Articles, countries are free to choose their capital account and exchange rate regimes with the proviso that they do not engage in currency manipulation. This is a basic pillar of our current system. The proviso has proved very difficult to define, let alone to implement. The IMF has met with some difficulties in trying to set up an efficient a symmetric process of multilateral surveillance.

And, third, we live in a world of greater interdependence and complexity. International capital flows have made countries truly interconnected. The monetary and financial system has become “multipolar”. An increasing number of countries, both developed and emerging, have become active participants in the global capital market. Spillovers between national monetary and economic policies have multiplied. And no country can truly be indifferent to actions taken by others.

In current circumstances, those three basic realities have become much harder to reconcile.

Divergences in monetary policies are unavoidable given the uneven paths of recovery across the world. And, for each country, this may be a time where price and financial stability objectives may not coincide. In advanced economies, monetary easing, together with inhibitions on credit growth, creates a potential for further financial imbalances. In many emerging countries, inflationary pressures would warrant monetary tightening but there is a clear risk this would trigger destabilizing capital inflows.

In those circumstances, there is a major role to play for macro prudential policies. For advanced economies, they should aim at spurring credit growth, while increasing the resilience of the financial sector. Supervisors should also stand ready to act if bubbles like phenomena appear in some markets. For emerging economies, measures aimed at stabilizing capital inflows may help and relieve the pressure on domestic financial conditions and prevent further asset bubbles.

International financial architecture

In the longer run, however, we may need to work together towards a more efficient and stable international financial architecture. Let me highlight three possible avenues for progress.

First, we have to find ways of dealing with international capital flows volatility. For one given country, capital controls may temporarily reduce the pressure on its capital account or even permanently limit the volatility of its exchange rate. For the whole international system, however, they may simply displace the pressure to other countries or asset classes and exacerbate, rather than reduce, overall volatility. There might be ways to eliminate those negative effects by creating a predictable framework defining the circumstances, modalities and conditions through which temporary controls would be implemented.

Second, there would be benefits in finding ways to disconnect reserve accumulation from exchange rate management and, more generally, from balance of payment situations and monetary policies. At present, reserve accumulation can only occur through a conjunction of balance of payment surplus and some degree of exchange rate intervention. Emerging countries have increased their foreign exchange reserves from 4 percent of GDP in 1990 to over 20 percent on average today. Precautionary reserve accumulation, however legitimate, unavoidably creates side effects for domestic macro policies as well as spillover effects on other countries. Stabilizing the demand for international reserves would therefore bring huge benefits in terms of world welfare. The need for national reserves could be reduced if credible mechanisms exist to provide for the supply of official liquidity on a multilateral basis. Hence the current search for international financial safety nets which has taken first stage in the G20.

Finally, I would like to say a few words about financial development. Differences between countries, are striking, whether one looks at capital account regimes, the broadness and debt of domestic financial markets or, more generally, their ability to generate locally a sufficient supply of safe and liquid assets. Some of those differences reflect true social choices and preferences that must be respected and accommodated. Others result from deliberate or inadvertent policy - induced distortions, which should be reduced or eliminated.

Domestic financial imperfections and frictions in international capital flows interact with each other to create and amplify imbalances. Ultimately, financial instability is a product of this interaction. Part of this instability shows up in exchange rates movements. It is very unlikely that a global capital market driven by constant frictions between highly different domestic financial systems would lead to a stable – and fundamentals based – equilibrium in foreign exchange markets.

Ensuring that our different financial systems interact harmoniously should be a policy priority. Greater compatibility in approaches to financial regulation between advanced and emerging economies is within reach. Significant advances are being made. The institutional framework has adjusted to the new world reality. Emerging economies, now fully take their part and role in the constellation of Committees which, in Basel, work on defining core principle of financial regulation. The largest sit as full members of the Financial Stability Board, and its steering Committee. Finally, a landmark agreement on IMF reform reached at the last G20 meeting has fully recognized their role and place in the new financial environment. I am therefore confident that we can – and will – make progress in tackling the difficult issues we face and build a better and safer world financial system.