Miguel Fernández Ordóñez: Global rebalancing, asset prices and policy responses

Opening remarks by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the Fifth High-Level Seminar of the Eurosystem and Latin American Central Banks, Madrid, 10 December 2010.

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Good morning and welcome again.

More than three years after the global financial system started to show serious signs of instability and two years after being on the verge of a global economic and financial meltdown, the world economy seems to have avoided that risk, backed by a strong and coordinated policy response. Nevertheless, the strengthening has been uneven and the risk of economic and financial instability is still persistent and significant in some regions, like the euro area. Indeed, it is hard to emphasise sufficiently the challenges ahead and how crucial the present juncture is for the future of our Monetary Union.

On the contrary, Latin American economies had learned the lessons from the severe financial and economic disruptions they experienced in the not so distant past, and the challenges they currently face are more similar to those that characterised the period of strong growth prior to the financial crisis. These very different sets of present circumstances make today's exchange of mutual experiences and policy discussion particularly interesting.

The title of today's Seminar was chosen almost a year ago, but it couldn't be more timely: ***Global Rebalancing, Asset Prices and Policy Responses***. From today's perspective, these three issues refer – more or less directly – to the basic challenges that will have to be tackled to make the present uneven and unbalanced global recovery sustainable.

With this in mind, I will organise my Opening Remarks around these three topics. First, I will deal with global rebalancing and how to achieve it in a context of diverging economic prospects for advanced and emerging market economies. Second, I will address the recent behaviour of global financial flows and the challenges that emerging market economies face in this regard, including the risk of asset price overvaluation. And finally, I will touch briefly upon the need to enhance policy cooperation at the global level, especially as some economies progressively leave the worst of the crisis behind.

Let me move now to the first issue: ***global rebalancing and the world economic outlook***. Although global imbalances were considered one of the major risks facing the world economy before the crisis, such risks did not finally materialise in the expected form of a disorderly adjustment of exchange rates, with disruptive effects on global financial stability. Nevertheless, even if large and unsustainable deficits financed by the accumulation of reserves by surplus emerging economies were not the ultimate cause of the global economic and financial crisis, it can still be argued that they provided support for the build-up of the financial excesses that led to it.

In the aftermath of the crisis, global imbalances were reduced as a consequence of the financial retrenchment and the severe downturn in activity worldwide. However, a large portion of the correction is likely to have been merely cyclical. As a matter of fact, as the global recovery is taking hold, a new widening of imbalances is starting to be perceived this year and is foreseen to continue into 2011. Indeed, the basic structural factors underlying global imbalances remain essentially in place; but the crisis has brought about some potentially important changes in the nature of the imbalances.

As trade and capital flows experienced a sudden stop during the crisis, the immediate impact was deeper in those economies more open to trade – which collapsed – and those with higher net external financing needs. When trade recovered, export economies tended to rebound strongly, but countries with large external deficits generally lagged behind. In many advanced economies, particularly in those running deficits, private domestic demand remains severely impaired by the adjustment process and the need for the private sector to deleverage. As a result of this process private sector saving rates have increased sharply and public sector balances have rapidly deteriorated. In the end, external deficits do not reflect anymore the large financing needs of the private sector – as they did before the crisis – but those of the public sector.

High fiscal deficits and rapidly increasing debt levels in most advanced economies are both a consequence of the crisis and of the policy response to it, as Governments tried to make up for the sharp collapse in private sector activity and to support their financial sectors, in a context of rapidly shrinking public revenues. Given the deep concerns about public debt sustainability brought about by these developments, a key policy challenge in most advanced economies is to achieve fiscal consolidation, even at a time of expected lasting weakness in domestic demand.

European economies have been acting resolutely in the pursuit of fiscal consolidation. In particular, Spain is undergoing an intense adjustment process which has halved the current account deficit (from 9,6% in 2007 to around 5% this year). The Government is implementing an ambitious fiscal consolidation plan, combining some tax increases with sizable spending cuts and, more importantly, adjustments to long-term expenditures, in particular to the pension system, all of which will have a strong positive impact on the long-term sustainability of public finances.

But the success of the adjustment will depend first and foremost on achieving a solid and sustainable growth rate. This goal requires implementing the necessary structural reforms to increase productivity and the efficiency of the economy, and establishing a more balanced and stable pattern of growth. The most important of these reforms have already begun to be introduced, in particular those bearing on the labour market and the financial sector, but continuous progress is needed.

The third pillar of the Spanish action plan is the restructuring of the financial sector and its adaptation to an economy less dependent on credit and leverage for growth. Restructuring turns on two essential aspects: the downsizing of the banking sector as a whole, and maintaining a sufficiently large backstop as to ensure the capital that is required, but using only that necessary so as not to overburden public debt, no matter how small the Spanish public debt is.

The hard times that characterise a protracted process of economic and financial adjustment are familiar to many Latin American countries, which have experienced sovereign and banking crises over the past decades. But they have avoided it this time. Indeed, Latin America has proved outstandingly resilient at a time of global hardship, as too have many emerging economies – perhaps with the exception of some Eastern European countries. Before the crisis, most Latin American countries had dramatically reduced their vulnerabilities, precisely as a result of the lessons learnt in the previous crisis. Accordingly, there were no severe problems of overborrowing or external imbalances of the sort experienced by industrial countries, and the current adjustment, while significant in size, has been swift. Recovery in Asia and Latin America is proving strong and driven increasingly by domestic demand.

All in all, improved fundamentals relative to industrial countries have placed emerging market economies in a much better position to resume high levels of growth. Going back to a debate that was popular in the first half of 2008, we can say that, after all, emerging countries have been able to "decouple" from the dire growth prospects of advanced economies.

But it is still uncertain whether solid growth in emerging economies can be sustained over the medium term if external demand from major industrial economies remains subdued for a protracted period. Moving one step forward, we can ask to what extent emerging economies can act as an effective engine for growth in advanced economies through their external demand. There are clear incentives for emerging market economies to forcefully promote the growth of their domestic demand and contribute, at the same time, to rebalancing the world economy and to rendering global growth more sustainable.

Let me now turn to the second topic: ***financial flows and financial globalisation***. Increased capital inflows into emerging market economies at a time of strong domestic growth is probably the central concern for these economies today; however, coming from a situation in which the risk of a "sudden stop" became very serious, at the end of 2008, the current bonanza does not appear such a bad outcome after all.

Yet large capital inflows together with strong domestic demand pressures combine to make for very expansionary economic conditions, posing risks to economic management in the form of overheating, inflation and appreciation pressures, credit booms and asset price overvaluation. Emerging economies have traditionally been more prone to "booms and busts" and "sudden stops" than more mature economies, and this helps to explain policy awareness when dealing with strong credit growth and currency volatility.

Total capital inflows into emerging market economies, and also into Latin America, have strongly rebounded from the fall in late 2008 and 2009, and are expected to continue to grow over the medium term. Driving these developments are a combination of solid economic prospects and sizable interest rate differentials relative to advanced economies. Which of these two factors dominates is hard to say ex-ante but has important implications in terms of economic policy management of the situation.

On the one hand, if current capital inflows to emerging markets simply reflect their perceived relative economic strengths going forward, they should be expected to be largely permanent, and therefore, an appreciation of their exchange rates would be taken as granted. Such a choice would provide monetary policies with more degrees of freedom, allowing for a tightening more suited to their cyclical conditions, and for a rebalancing of growth towards domestic demand.

However, should short-term interest rate differentials also be playing a role in explaining this new wave of inflows, then the reluctance of emerging market countries to tolerate large appreciations would be understandable, also because the most dynamic components of the inflows – portfolio equity and debt flows – are the most volatile and subject to eventual reversals. However, limiting upward exchange rate flexibility may attract more capital inflows, on the expectation of future appreciations, turning thereby into a self-defeating strategy.

In summary, choosing the right policy mix has become a challenging task for many emerging market economies, all the more so in the absence of a globally coordinated policy response.

Faced with these uncertain times, Latin American economies are applying a mix of policies to attain their multiple objectives and minimise risks. The mix includes, to differing degrees of intensity, monetary policy tightening, foreign exchange interventions and reserve accumulation, macro-prudential policies and, in some cases, capital controls.

The use of capital controls has traditionally been controversial, because they distort markets while their effectiveness is not backed by empirical evidence. But we must acknowledge that there has been a shift in opinion in their favour – at least as a last-resort instrument – even among institutions such as the IMF. In turn, this shift probably reflects a change in the perceived balance of benefits and costs associated with financial excesses.

Nevertheless, it is important to bear in mind that capital controls can also entail negative externalities for the global economy. While fully convinced of the benefits of financial globalisation, a topic to which we devoted our Seminar in 2006, I am concerned by the risks of financial deglobalisation arising in the wake of the crisis. There is much discussion on the risks of trade protectionism as a consequence of the crisis, but the risks of financial protectionism are at least as significant and probably more evident. For instance, national rescue plans to address the financial crisis may have jeopardised the level playing field that must underpin cross-country financial flows. In a similar vein, capital controls could induce market segmentation and trigger a spiral which would erode some of the progress achieved in financial integration over the past decades.

Let me be more specific on banking flows and the lessons from the global financial crisis. The crisis has emphasised the vulnerability of cross-country banking flows, and how quickly they may retrench in times of stress. Such retrenchment was an important transmission channel of financial strain during the global financial crisis. However, not all banks behaved equally; lending by some proved more resilient than others. Recent research[1] on the performance of cross-border lending to emerging markets during the recent crisis has yielded a number of interesting conclusions. Among them, that lending by Spanish banks to Latin America was more resilient than lending by other international banks, and that by behaving like domestic banks they did not contribute to the impact of foreign shocks on credit and interest rates.

The relative stability of Spanish banking flows has to do with both the banking business model and the quality of supervision. Spanish banks in Latin America have traditionally operated under a subsidiary model, whereby they are financially autonomous from the head office and they have to comply with the host country's capital requirements and deposit insurance schemes. In turn, supervisory responsibility is shared between the host country and the home country supervisors.

Another factor of resilience behind the business model of Spanish banks in Latin America is their focus on retail banking, which tends to be less volatile and more closely linked to the real economy than wholesale or investment banking. Both the emphasis on retail banking and the principle of financial autonomy of the subsidiaries induce banks to fund themselves primarily through the deposit base in the host country. This reliance on domestic funding has favoured "business as usual" even if the home country was enduring financial stress, and has helped to reduce the financial vulnerability of the host country by mitigating the exposure to external flows.

I am aware that even if the subsidiary model has proved its resilience during the crisis, it may involve some costs in terms of liquidity management, and that alternative banking models may have their virtues depending on the nature of the banking business. With due attention to limiting financial vulnerabilities, the question of models for cross-border banking has to be addressed with the necessary flexibility.

In any case, the relatively mild recession and the favourable prospects for banking business in Latin America have encouraged Spanish banks to maintain or even increase their activity in the region at a time of hardship at home. This last factor is indeed an example of the benefits of preserving financial globalisation: strong economic prospects in Latin America have helped Spanish companies to build an important buffer against the deterioration in the domestic market, with an important contribution to our own financial stability.

Let me briefly address my third and final point today: the need to maintain the highest degree of ***global policy cooperation***. The immediate crisis response by the international community was first coordinated in the revamped G20. The crisis showed, on the one hand, that the national policies of systemic economies had long neglected the spillovers of their own policies on other countries and, at the same time, that some of these policies entrenched unsustainable patterns of growth. In addition, as mentioned before, the crisis exposed countries to sudden and severe liquidity shortages. Against this background, the G20 has pledged a significant strengthening of both global surveillance and global financial safety nets.

The measures taken and the coordination involved highlight the remarkable unity achieved in response to the crisis. However, as the recovery gathers steam at different speeds, some

[1] See Kamil and Rai (2010), Galindo, Izquierdo and Rojas-Suarez (2009).

dissent has surfaced. Although differences in policies are not completely unexpected now that the collapse scenario has been reduced, they do show that the international financial architecture still lacks sufficient leverage to coordinate the interests of the different countries.

Symptoms of imperfect coordination can be seen across the board today and, unfortunately, the euro area is no exception. As I have mentioned and illustrated above, a lack of coordination leads to national responses which can generate negative externalities. Recovering the sense of common purpose shared at the height of the crisis remains of the essence when designing the right policies at the global level. In these circumstances, it would be of paramount importance to reinforce the efforts to keep cooperation and dialogue open, and this Seminar is intended to contribute to that goal.

The other area where international cooperation is definitely needed is in the construction of global safety nets as a way to reduce global financial risks. A wider use could help mitigate certain policies that may be detrimental to global stability from a collective standpoint, such as excessive reserve accumulation. In that respect, additional work is needed to improve the incentives associated with IMF lending facilities for emerging market economies and to address more effectively the traditional problems associated with them (for instance, the stigma problem). International fora are well suited for resolving these coordination problems.

That brings me to the end of my introduction to the Seminar. As you can see in the programme, there will be three sessions which will take up each of the topics I have just addressed. Each session has been organised as a panel discussion so as to facilitate the presentation and exchange of different views, with three panellists from both sides of the Atlantic. After each panel, we have allotted sufficient time for an open general discussion. Finally, at the end of today's proceedings, President Trichet will make the closing remarks of the Seminar. I hope we will have an intense and very productive day's discussion.

Without further delay, I give the floor to my friend Governor Carlos Costa, who will chair the first session of the seminar on global rebalancing.

Thank you