

Benoît Cœuré: Global liquidity and international risk-sharing in the post-crisis environment

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the Bank of Korea International Conference 2013 “Assessing global liquidity in a global framework”, Seoul, 3 June 2013.

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I wish to thank Roland Beck and Georgios Georgiadis for their contributions to these remarks, as well as Georges Pineau for his comments. I remain solely responsible for the opinions contained herein.

Ladies and Gentlemen,

Let me first thank the Bank of Korea for the kind invitation to this conference, which is taking place at a critical time for the global economy. I am delighted that the organisers selected “Global Liquidity in a Global Framework” as the theme for this year’s International Conference. It is indeed essential that the central bank community makes further progress on this important issue.

Let me briefly recall how we arrived at this point. Against the background of the G20’s work on global liquidity management, the BIS – via the Committee on the Global Financial System (CGFS) – undertook important groundwork leading to the Landau Report of the CGFS.¹ The IMF carried out important complementary work in response to the G20’s initiative in 2011.² And the central bank community as well as academia were closely involved in these joint research efforts. The ECB, for its part, hosted a joint workshop with the BIS on global liquidity and its international repercussions in February 2012. Since then, further progress has been made and it is a good time to take stock of where we stand.

The measurement of global liquidity and its drivers

The CGFS has established a relatively broad definition of global liquidity by referring to the “ease of financing” at the level of the global financial system.³ This definition includes official liquidity and private liquidity.

An important observation with regard to the drivers of global liquidity is that while official liquidity can ultimately only be created by central banks, private liquidity is pro-cyclical and highly endogenous to the conditions that prevail in the global financial system. As a result of this, there is, as I explained elsewhere in more detail, a “self-reinforcing interaction between risk appetite and liquidity”.⁴

Against this backdrop, a relatively large set of indicators has been proposed to monitor trends in global liquidity. But how many of these quantity- and price-based indicators are really relevant for policy-makers and show developments which are “orthogonal” to what the other indicators show? Recent research has found that a large set of financial and macroeconomic indicators for global liquidity can be represented by three main factors which can be labelled “monetary policy”, “credit supply” and “credit demand”. These three structural

¹ See Committee on the Global Financial System, “Global liquidity – concept, measurement and policy implications”, CGFS Paper No 45, Bank for International Settlements, Basel, November 2011.

² See e.g. S. Chen, A. Maechler, S. Saksonovs, and H. Shin, “Exploring the Dynamics of Global Liquidity”, IMF Working Paper 12/246, October 2012.

³ See CGFS (op. cit.).

⁴ See B. Cœuré (2012), “Global liquidity and risk appetite: a re-interpretation of the recent crises”, speech at the BIS-ECB Workshop on Global liquidity and its international repercussions, Frankfurt am Main, 6 February 2012.

liquidity factors have contributed to shaping global financial dynamics in the run-up to, and in the aftermath of, the financial crisis (see slide 2). Before 2007 global credit supply was a driving force of low interest rates and rapid credit expansion, while since 2008 looser official liquidity has partly compensated for tighter private liquidity (see slide 3).⁵ While such purely statistical exercises should be always treated with caution, it is encouraging that there is a broad agreement on the main drivers of global liquidity in the academic literature.⁶

A long-term view on international risk sharing and financial globalisation

A lot of attention is currently being paid to the negative externalities associated with fluctuations of global liquidity. One prominent example is the discussion about the international spillovers of unconventional monetary policies in the advanced economies.

Clearly, sustained low interest rates and domestic bond purchases by central banks can spill over to asset prices elsewhere. Recent empirical studies indicate, however, that the effect of the various rounds of QE policies by the US Federal Reserve has so far had a relatively small, albeit pro-cyclical, global impact.⁷

Furthermore, the international transmission of unconventional monetary policies is not homogeneous. The first round of QE in the US, mainly aimed at improving market functioning, had a smaller impact on equity markets and exchange rates in emerging market economies (EMEs) than the second round of QE policies implemented through large-scale asset purchases (see slide 4). In addition, “pull-factors” such as positive growth differentials and financial deepening in EMEs have also been important drivers of capital flows to these countries (see slide 5). Likewise, while the Bank of Japan’s new monetary policy strategy prompted fears of a “currency war”, it is not proven so far that its global impact could be negative. Nevertheless, this is an important debate, and we have to take the arguments put forward by EME policy-makers seriously.

However, the current debate focuses too much today on the negative externalities of domestic monetary policy decisions, and overlooks the fact that global liquidity is closely intertwined with the degree of international risk-sharing.

International risk-sharing is usually defined as a situation where fluctuations in consumption are decoupled from idiosyncratic fluctuations in output, and where consumption growth rates across countries are highly correlated. The disconnect between consumption and output is of course made possible by lending to, and borrowing from, abroad, hence by cross-border liquidity flows. Access to a *complete* set of contingent financial assets in the sense of Arrow and Debreu would allow countries to perfectly insure against idiosyncratic risk. As is well known from the theoretical literature, the benefits of international risk-sharing may be considerable and should not be underestimated.⁸

⁵ See S. Eickmeier, L. Gambacorta and B. Hofmann, “Understanding Global Liquidity”, BIS Working Paper No 402, February 2013. In addition, the relative importance of global liquidity factors varies across regions. For instance, M2 growth seems dominated by the “credit supply” factor in the euro area, while it is dominated by monetary policy and macro factors in emerging Asia.

⁶ See for example V. Bruno and H. Shin: “Capital Flows, Cross-Border Banking and Global Liquidity”, Princeton University, mimeo.

⁷ See M. Fratzscher, M. Lo Duca and R. Straub, “A global monetary tsunami? On the spillovers of US Quantitative Easing”, CEPR Discussion Paper No 9195, October 2012.

⁸ See M. Obstfeld, “Evaluating risky consumption paths: The role of intertemporal substitutability”, *European Economic Review*, vol. 38, no. 7, August 1994, pp. 1471–86, and “Risk-taking, global diversification, and growth”, *American Economic Review*, vol. 84, no. 5, December 1994, pp. 1310–29. See also more recently, K. Lewis and E. Liu, “Evaluating International Consumption Risk Sharing Gains: An Asset Return View”, October 2012, working paper presented at the 2013 American Economic Association meeting.

One simple metric often used to gauge the extent of international risk-sharing is the ratio of gross foreign assets relative to GDP in major economies. This measure has the advantage of being able to draw on historical time series, allowing us to look at long cycles in financial globalisation.

Let's look back for a moment. During the first wave of financial globalisation, which was driven by the British, who were often called the “bankers to the world”, foreign assets relative to GDP reached a peak between 1900 and 1914 (see slide 6). Following a sharp decline from 1914 to 1945, the share of foreign assets returned to its previous levels only by 1990. The period between 1990 and the global financial crisis was marked by extensive financial liberalisation, which led to an unprecedented rise in foreign asset positions. Since the crisis started this process appears to have levelled off. I will come back to this in a moment.

The euro was introduced in 1999 in a region where all restrictions on capital movements had been lifted. It is no surprise then that unleashed financial forces led to an expansion of intra-regional cross-border capital flows (mostly flowing from “core” to “peripheral” euro area economies), exploiting the expanded risk-sharing opportunities created by the single currency. We now know that risk was neither well assessed nor well monitored, and that unchecked cross-border lending supported projects with low intrinsic profitability, such as in the housing sector. Moreover, the structure of these flows (i.e. wholesale interbank credit, rather than direct loans to firms or capital market investment) was inherently fragile. Credit between institutions with domestic deposit bases and implicit guarantees from their own governments soon fragmented along national lines when the financial crisis erupted and shook confidence in banks.

Let me highlight two salient features of the recent wave of financial globalisation, which have important consequences for the post-crisis steady state.

The first feature is the geography of wealth transfers before and after the global financial crisis. As the academic literature⁹ indicates, the US external balance sheet displays a very specific pattern: short in “safe” or liquid securities and long in “risky” or illiquid ones. This implies that the US earned a risk premium before the global financial crisis, but suffered disproportionate losses during the crisis, when the value of its risky external financial portfolio collapsed relative to the value of its safe external liabilities.¹⁰ In other words, the United States acted as the world's global insurer (see slide 7). As noted by the same literature, the euro area and Switzerland have played a comparable role, albeit at a regional level and on a smaller scale.

Within the euro area, Germany has played a similar role as the United States at the global level: it was the “regional insurer” in the run-up to the crisis, investing in risky assets in other euro area countries while selling safe government bonds. Note that Germany did not need to run a current account deficit to play this role, confirming the modern disconnect between international risk-sharing and flows of goods and services.

Another salient feature of the recent wave of financial globalisation is the role of cross-border banking and the interaction between liquidity cycles and the leverage of global banks.¹¹ Before the crisis, the expansion of cross-border lending (and hence of international risk-taking) was made possible by increased bank leverage in a period when perceived risk was

⁹ See P.O. Gourinchas and H. Rey (2007), “From World Banker to World Venture Capitalist: U.S. External Adjustment and the Exorbitant Privilege,” in Clarida, R., editor, *G-7 Current Account Imbalances: Sustainability and Adjustment*, pages 11–55, Chicago, University of Chicago Press, and M. Habib, “Excess returns on net foreign assets – the exorbitant privilege from a global perspective”, ECB Working Paper No 1158, 2010.

¹⁰ See P.O. Gourinchas, H. Rey and N. Govillot, “Exorbitant Privilege and Exorbitant Duty”, 2010, mimeo.

¹¹ See H. Shin, “Global Banking Glut and Loan Risk Premium”, presented at the 12th Jacques Polak Annual Research Conference, International Monetary Fund, Washington DC, 10–11 November 2011.

low – in other words, there was “excess elasticity” in the global credit supply.¹² The intermediation role of European banks in the global dollar-denominated market before the crisis is a case in point.

Following the crisis, global banks retreated from cross-border lending, amplifying the impact of the financial crisis on those economies that did not have alternative sources of funding, and prompting partial substitution by official credit. This happened both at the global level after the demise of Lehman Brothers, prompting large-scale intervention by the IMF and by multilateral development banks, and within the euro area after 2010, prompting official support through the EFSF and ESM, and liquidity support by the Eurosystem to banks in stressed jurisdictions. Here again, the euro area can be seen as a microcosm of the global economy – just as a Korean garden is a microcosm of nature.

Global liquidity and international risk-sharing in the current environment

One important point in this context is the emergence of a “home bias” and de-globalisation following the global financial crisis.

These trends have profound effects on the degree of international risk-sharing. But are they only temporary or do they constitute a level shift in the steady-state level of financial integration?

An optimistic view is to consider the global financial crisis as a temporary shock, which impact will fade away.

The persistence of a shock, however, depends on the structural and institutional features of an economy, as well as the corresponding policy response. And there are some worrying signals at the global level. In the following brief examples, I will illustrate how the interaction of institutions and shocks can shape the new post-crisis steady-state level of financial integration.

In advanced economies, for example, financial regulation and other forms of public intervention have contributed to global fragmentation. Government bail-outs, risk-based capital requirements and the ring-fencing of capital and liquidity by local supervisors have constrained banks’ risk-taking outside domestic jurisdictions.¹³ In the euro area, this has been compounded by the perception of a rising risk of sovereign default, eroding the fiscal backing of cross-border liquidity provision.¹⁴ As a result, the rise in idiosyncratic country risk in peripheral countries and the associated increase in government bond yields was accompanied by a steady increase in the share of domestic holdings of government debt securities (see slide 8).

Financial fragmentation can, however, also be observed at the global level. Looking at banking statistics in advanced economies, the relationship between domestic and international bank lending has steepened compared with the pre-crisis credit boom (see slide 9).

This is also reflected in the re-emerging correlation between domestic saving and domestic investment, known as the Feldstein-Horioka puzzle. This is not only driven by declining

¹² See C. Borio and P. Disyatat, “Global imbalances and the financial crisis: Link or no link?”, BIS Working Paper, No 346, 2011.

¹³ For a discussion on the role of institutional features in the transmission of financial shocks from Japan to the United States, see J. Peek and E. Rosengren (1997), “The International Transmission of Financial Shocks: The Case of Japan”, *The American Economic Review*, Vol. 87, No. 4 (Sep., 1997), pp. 495–505.

¹⁴ On the importance of fiscal support to international liquidity provision, see M. Obstfeld, “International Liquidity: The Fiscal Dimension”, keynote speech at the Bank of Japan, Institute for Monetary and Economic Studies, Tokyo, 2–3 June 2011.

current account positions in euro area economies. Similar trends can be observed in other non-euro area OECD countries (see slide 10). In emerging economies, there seems to be some decline in financial openness that may be partly associated with policy responses to international spillovers of unconventional monetary policies (see slide 11).

Of course, reducing external exposure can be warranted if it is driven by risk-return considerations. European banks, for example, responded to deleveraging pressures by reducing the exposure to dollar-denominated assets, decreasing thereby their reliance on volatile US dollar funding (see slide 12).

Overall, the deleveraging of European banks had far-reaching global implications. In Asia, for example, the share of euro area banks in the provision of cross-border credit has declined, particularly in areas such as infrastructure and trade credit. (see the left panel of slide 13). Regional Asian banks took advantage of this opportunity and increased their share in cross-border credit (see the right panel of slide 13). Similar patterns can be observed in Central and Eastern European countries. This implies that risk-sharing is increasingly concentrated at the regional level.

Whether the regionalisation of risk-sharing will be lasting, and whether it will make the global financial system more robust, are open questions for researchers and policy-makers. Europe offers a sobering lesson in this respect. The single currency has made participating economies more resilient to global shocks, but it has magnified the impact of regional shocks, given the initial absence of a regional financial safety net.

Conclusions and lessons for policy-makers

Let me conclude. Global liquidity is an important concept and our understanding of its drivers and its effects has improved considerably over the past two years. The further evolution of global liquidity will depend on the way world trade and investment, and the related financial flows, globalise and sometimes de-globalise, and this in turn depends on policy reactions to the financial crisis.

Overall, these trends will have profound effects on international risk-sharing, which for the time being appears to have decreased or at least levelled off in the immediate post-crisis environment.

The world has gained a lot from being financially open and the benefits from international risk-sharing should be preserved. Current concerns related to international spillovers of unconventional monetary policy in the major advanced economies must not lead to a rise in financial protectionism. When confronted with a surge in capital flows, the first line of defence should always consist in macroeconomic adjustment. Capital flow management measures are also available but they should be used exceptionally and on a temporary basis if all other policy options have been exhausted, as the IMF has recently said.¹⁵

In advanced economies, post-crisis policy interventions should avoid encouraging financial fragmentation by confining banks' risk-taking to domestic jurisdictions. This is why achieving a level-playing field in the implementation of new financial regulations is so important. This is also why the European banking union project, with its single supervisory and its single resolution mechanisms, matters so much. It is only by restoring the free flow of capital within the euro area that the full benefits of Economic and Monetary Union can be reaped, and growth can restart in Europe.

Concerns related to the "excess elasticity" of global credit supply and the pro-cyclical nature of private liquidity need to be addressed *ex ante* if we want the international monetary and

¹⁵ See International Monetary Fund, "The Liberalization and Management of Capital Flows: An Institutional View", Washington, 14 November 2012.

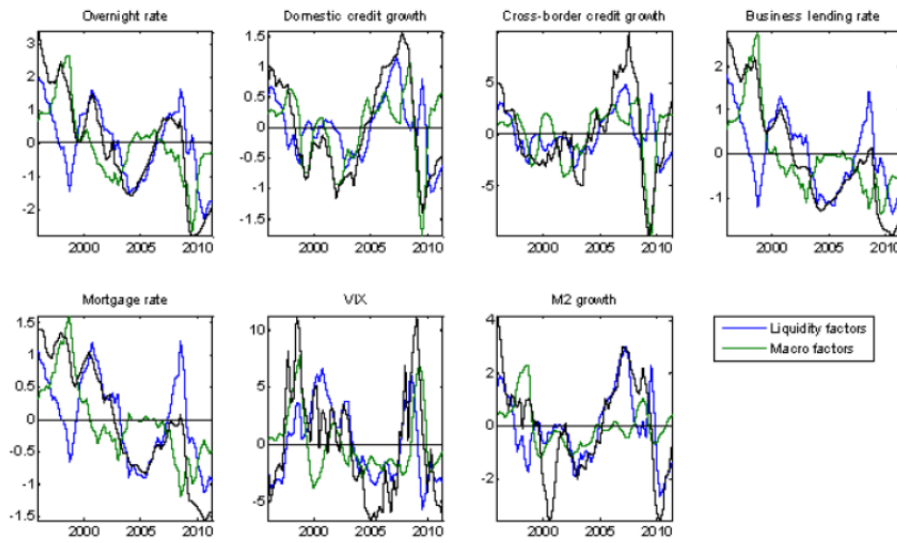
financial system to become more resilient to shocks. This is currently being done in various policy circles, particularly in BIS- associated committees. It covers not only work achieved within the Basel III framework to improve the resilience of systemically important banks to shocks to their capital and liquidity, but also ongoing work related to financial market infrastructures and the regulation of shadow banking. This work is geared at improving the resilience of individual institutions but also, and maybe more importantly, at dampening the global financial cycle. If well coordinated at the international level, the new micro- and macro-prudential instruments should go a long way in addressing global liquidity issues and potential imbalances.

Further reflection is also warranted on the provision of public liquidity, i.e. precautionary foreign-exchange reserve holdings and on international coordination in the face of global liquidity shocks. The rise of regional risk-sharing, if confirmed, will make regional financing arrangements (such as the European Stability Mechanism and the Chiang Mai Initiative) even more useful, but it will also call for fresh thinking on their interaction with each other and with global financial safety nets.. Following the seminal work of the G-20 Korean Presidency, I expect that the IMF will be doing further work in this area.

However, improved global and regional safety nets cannot and should not substitute for resilient banks and capital markets and strict risk management in the financial industry. To borrow from the theory of insurance, we should strike the right balance between ex-post and ex-ante efficiency. At a domestic as well as at a global level, public balance sheets can expand during a crisis only if they can revert to normal thereafter, letting private transactions thrive again, and if the associated moral hazard is mitigated by strong prudential policies. Only then will a “third wave” of financial globalisation benefit from the lessons of the past.

Thank you for your attention.

Global liquidity and macro factors

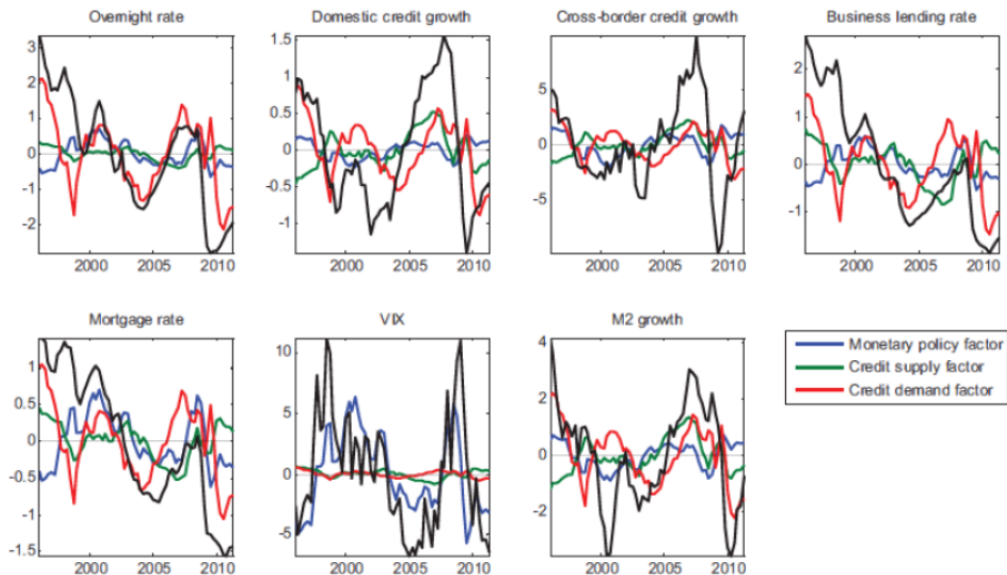


Source: Eickmeier, Gambacorta and Hofmann (2013), Figure 4(a).

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The role of global liquidity factors in shaping global financial dynamics



Source: Eickmeier, Gambacorta and Hofmann (2013), Figure 4(b).

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Limited spillovers from the Fed's QE policies so far

Non-standard monetary policy measure	Domestic long-term bond yields	Domestic equity prices	Global equity prices	EME equity prices	Exchange rate	VIX
QE1	-100bp	+25%	+20%	+7%	0 (effective)	(-)
QE2	0	+10%	+12%	+15%	-2% (effective)	(-)
QE3	-		+1.5%		-1.8% (against euro)	-1.3pp

Sources: Fratzscher, Lo Duca and Straub (2012), and ECB compilations.

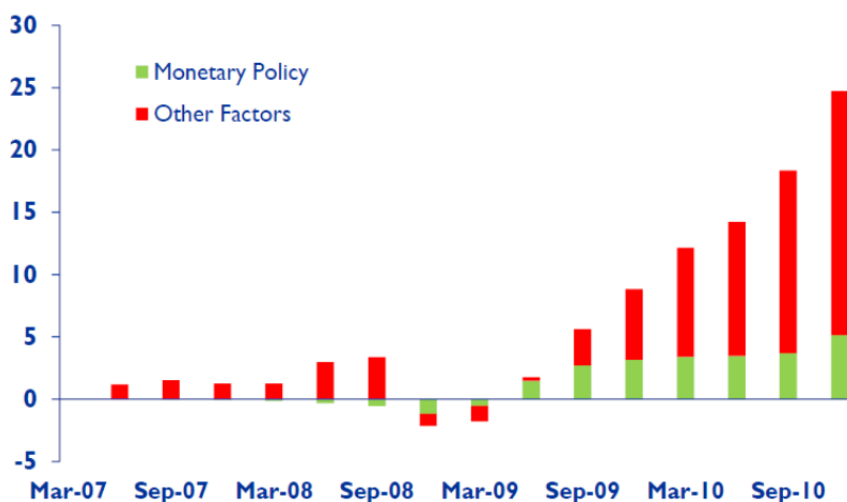
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Pull factors have been important for capital flows

Estimated cumulated impact of US QE on equity flows to emerging markets

(in % of assets under management)



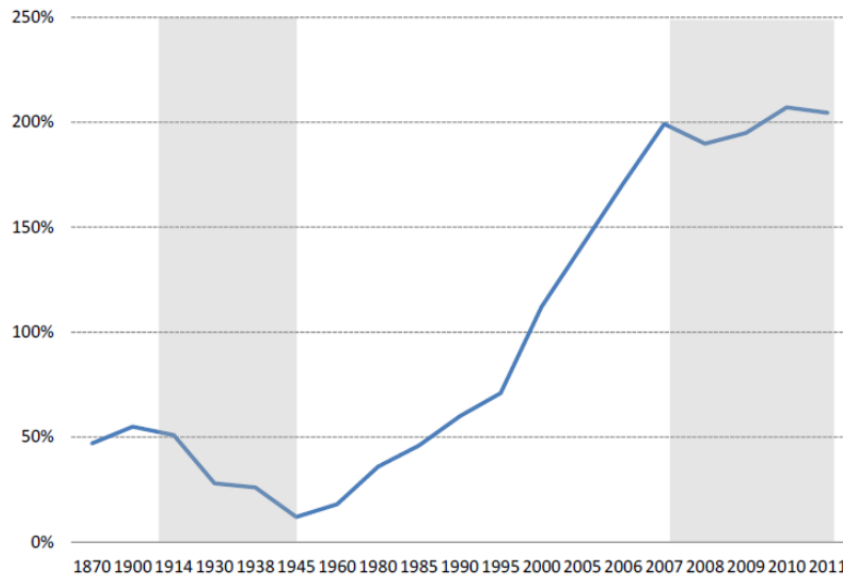
Source: Fratzscher, Lo Duca and Straub (2012).

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Long cycles in financial globalisation

Foreign assets of major economies
(in % of sample GDP)



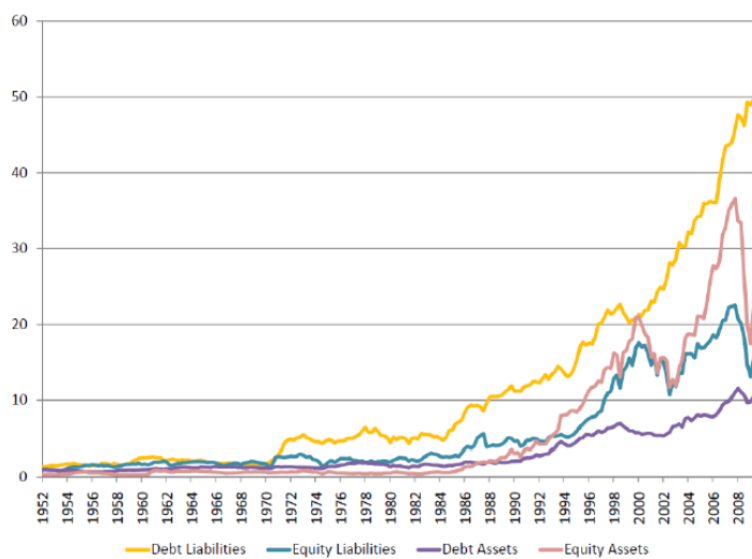
Sources: Obstfeld and Taylor (1994), IMF and ECB calculations.
Notes: Data from 1870 to 2000 are from Obstfeld and Taylor (1994) and refer to the UK, France, Germany, Netherlands, United States, Canada, Japan and "other Europe". Data for 2000 to 2011 refer to IMF data for the same countries, excluding "other Europe".

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The geography of wealth transfer before and after the global financial crisis

US external debt and equity
(in % of GDP)



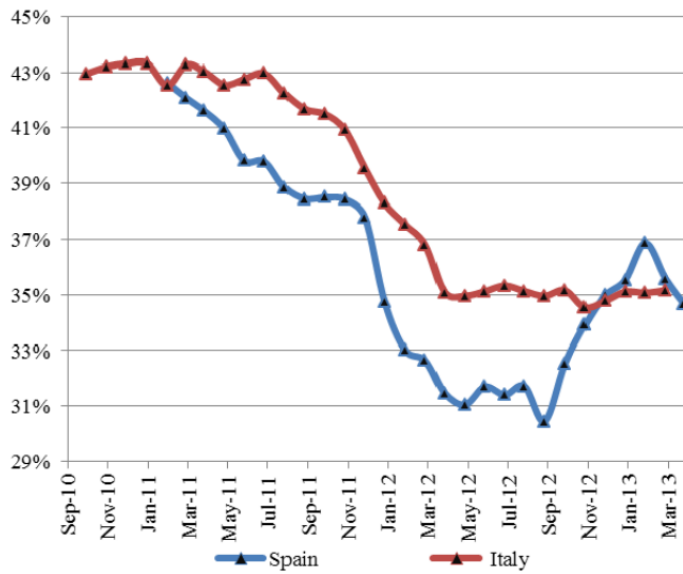
Source: Gourinchas, Rey and Govillot (2012).

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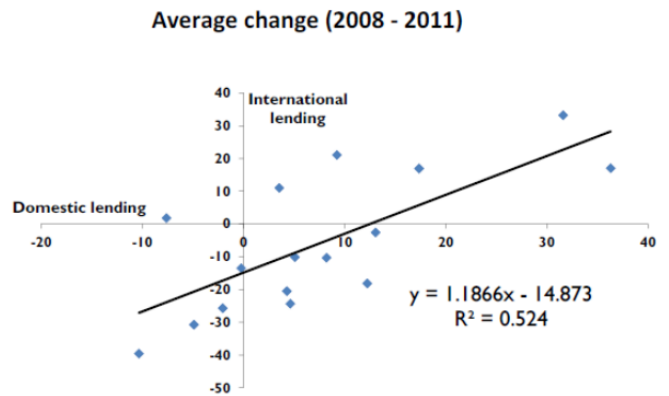
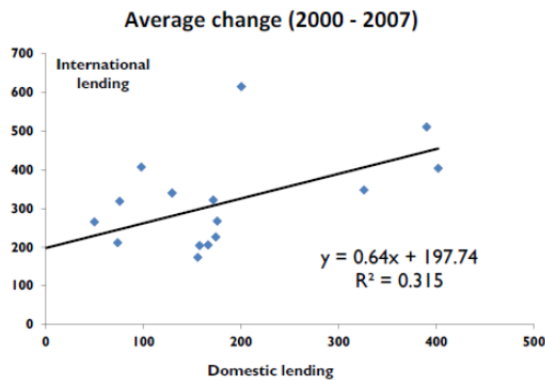
Financial fragmentation within the euro area

Non-resident holdings of government debt securities



Sources: Tesoro and Banca d'Italia.

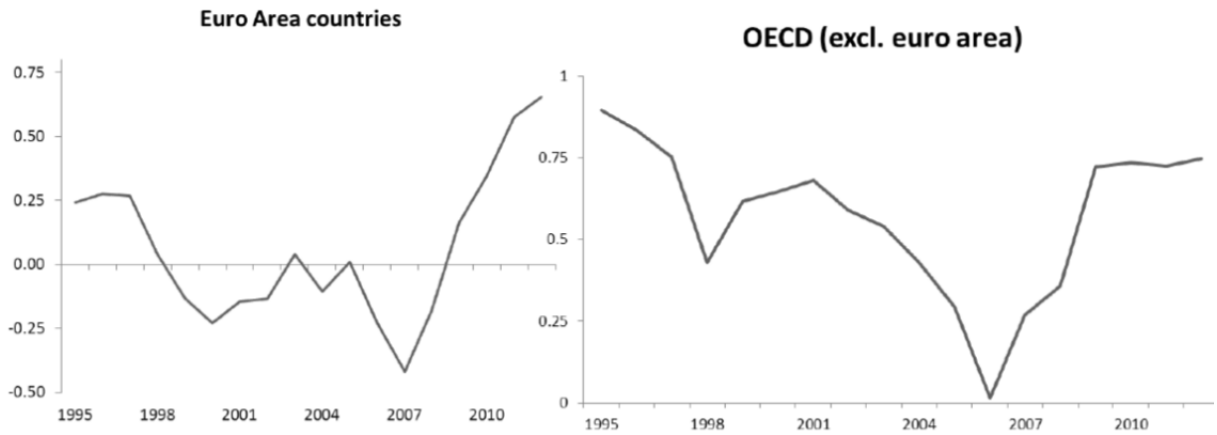
“Home bias” during periods of deleveraging



Sources: IMF, World Bank and ECB calculations.

Notes: The country sample refers to advanced economies including Australia, Austria, Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Japan, Netherlands, Portugal, Spain, Sweden, the United Kingdom and the United States.

The changing correlation of saving and investment



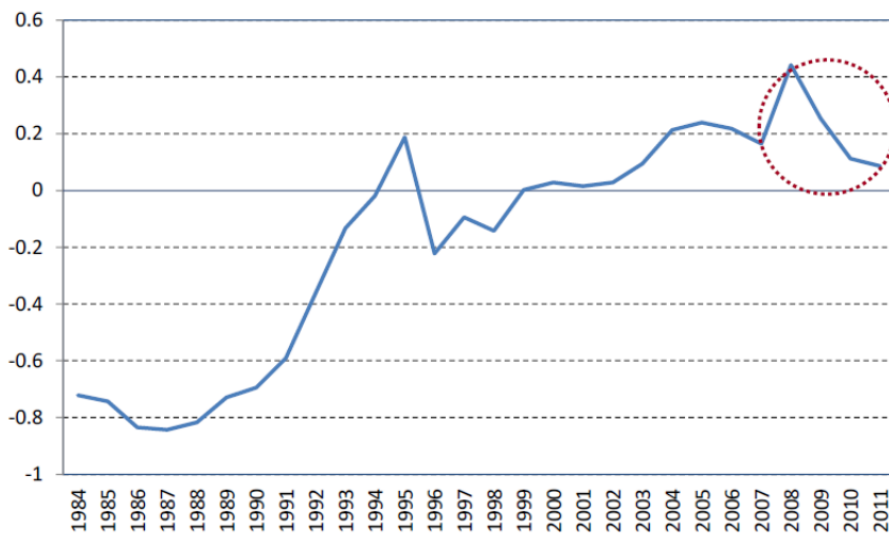
Sources: IMF and ECB calculations.

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Financial openness at risk?

Index of capital account openness for emerging markets
(normalised score, averages)



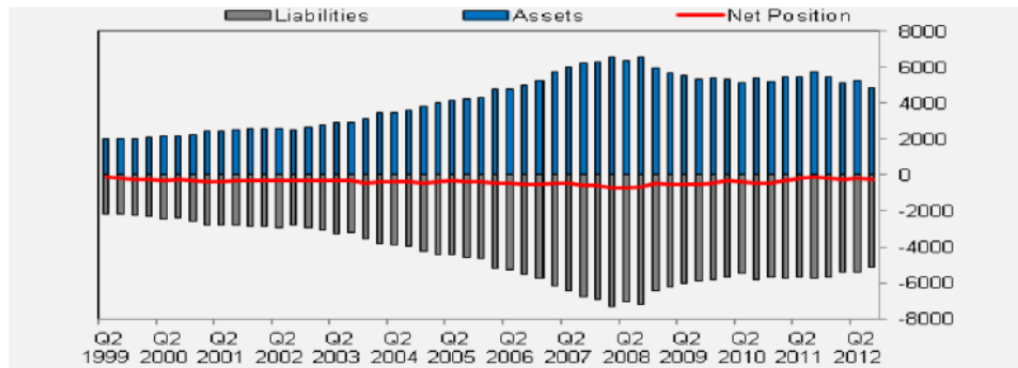
Source: Chinn and Ito (2006 and 2013).

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Gradual reduction of US dollar positions of European banks

Gross and net US dollar positions of European banks
(US dollar billions)

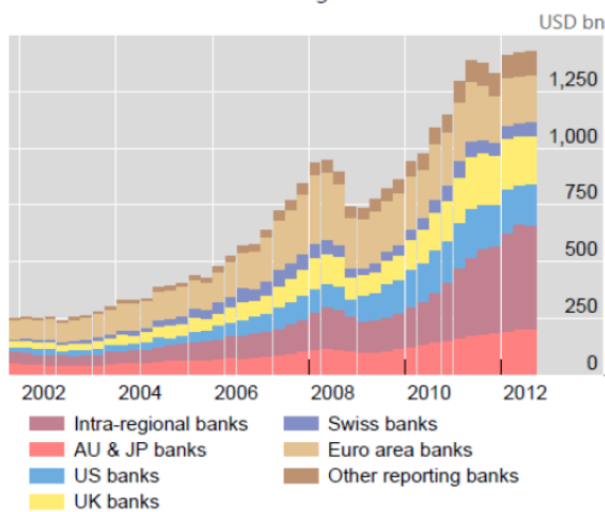


Source: Bank for International Settlements.

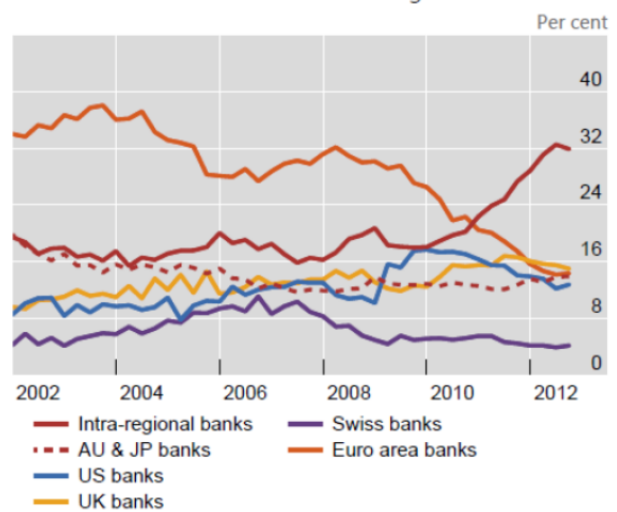
Deleveraging of euro area banks in Asia

Credit to emerging Asia-Pacific

International claims on the region¹



Share in international claims on the region



Source: BIS consolidated banking statistics (immediate borrower basis).

Notes: ¹ Sum of all cross-border claims and locally extended claims in foreign currency. ² Intra-regional share is the sum of international claims on the emerging Asia-Pacific region of banks headquartered in Chinese Taipei, Hong Kong SAR, India, Singapore, and outside-area banks (assuming these are headquartered in Asia).