

Benoît Cœuré: The case for rethinking international capital flows

Dinner speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the SUERF/PSE/CEPII Conference on “Rethinking Capital Controls and Capital Flows”, Paris, 15 September 2016.

* * *

The rise of financial globalisation is a defining phenomenon of the past 30 years. In the aftermath of the global financial crisis, financial globalisation stalled.¹

While it appears to be picking up again on some measures, it is not clear whether this recent episode marks a new era of somewhat lower integration, signals the start of a wider “deglobalisation” trend, or is merely a pause.

For long, the prevailing consensus among economists and international organisations had been that financial globalisation is unconditionally desirable, and a key to development and growth. Recent events – including the global financial and the European sovereign debt crises – shattered that consensus. There is now widespread acceptance that where financial markets are imperfect and regulatory and supervisory policies inadequate, capital inflows can fuel costly boom-and-bust cycles.

I believe that reducing financial integration and restricting capital flows alleviates the symptoms, without addressing the root causes. Worse, the remedy of financial protectionism has – just as with trade protectionism – adverse side-effects of its own that reduce economies’ growth potential. Over time, these adverse side effects may reduce welfare by more than the problems they seek to address.

We have to redefine the concept of globalisation. For this, we should adopt policies that allow us to reap the benefits from financial globalisation, while at the same time reduce its risks. Let me call this financial globalisation 2.0.

The key theme of these policies should be that they target the root causes of the risks of capital flows. To best harness the growth potential of financial globalisation, policymakers need to ensure it is **efficient**, **enduring** and **equitable**. Making financial globalisation *efficient* involves channelling capital flows to productive uses, rather than fuelling inefficient consumption-led boom and busts. Making financial globalisation *enduring* involves monitoring, and where necessary tilting the composition of flows towards less volatile types and avoiding risky gross positions, reducing the likelihood of sudden stops. And making it *equitable* involves addressing its distributive impact, both across and within countries.

While my talk today is of worldwide relevance, it is particularly pertinent to the euro area. Freedom of movement of capital is one of the four basic freedoms of the single market. Increasing financial integration by completing the capital markets union will help ensure that capital flows to where it can be most productively used to boost growth and employment, while minimising its side effects.

¹ The strong upward trend in de facto stock measures of international financial integration (such as gross foreign assets and liabilities as outlined in Lane and Milesi-Feretti’s External Wealth of Nations Database; see <http://www.philiplane.org/EWN.html>) as well as de jure measures of capital account openness (for example as developed in Chinn and Ito (2006), “What matters for financial development? Capital controls, institutions, and interactions,” *Journal of Development Economics*, Elsevier, vol. 81(1), pages 163–192) observed since the 1990s stalled in 2008/09, but have started to exhibit some increase in recent years again.

The benefits and risks of financial globalisation

Let me spend a few moments recalling the textbook benefits of financial globalisation. In principle, free capital flows allow for risk sharing and a better allocation of resources across economies.²

They also help economies to catch up in terms of technology and financial market development through the transfer of knowledge, a critical determinant of growth. In addition to these basic growth channels, economists have pointed out that financial globalisation can foster growth by facilitating risk-sharing and consumption smoothing (particularly at a time of severe demographic challenges), by allowing specialisation, and by imposing external discipline on domestic economic policies.

But recent academic analysis and policy experience, both globally and at the euro area level, have revealed that the story is not quite as simple.³

Capital flows can pose risks. They can be volatile and pro-cyclical, fuelling economic and financial cycles, and eventually asset price bubbles.⁴

Such bubbles are typically associated with a misallocation of resources, which can persistently drag on growth and employment.⁵ And international gross positions can also reflect to a large extent regulatory or tax arbitrage, and therefore arise from an uneven regulatory playing field rather than from an optimal co-operative equilibrium.⁶

The composition of flows has important implications for the likelihood of sudden stops and reversals. In particular, financial globalisation in assets with longer maturity and state-contingent payoffs – such as equity and foreign direct investment (FDI) – has been shown to be less volatile than one based on short-term bank or portfolio flows.⁷

FDI is also more desirable as it is much less sensitive to global push factors, such as global risk aversion or monetary policy in major economies.⁸ The evidence for positive growth effects of FDI in the literature is much more robust than for portfolio flows.⁹

Furthermore, the focus of the discussion on financial globalisation had typically rested on net flows, as reflected by the current account. However, the global financial crisis has shown that

² See Obstfeld, M. (1994), “Risk-Taking, Global Diversification, and Growth”, *American Economic Review*, Vol. 84, no. 5, pp. 1310–1329.

³ For a more elaborated exposition of these issues, see also “Paradigm lost: Rethinking international adjustments” Speech by Benoît Cœuré, Member of the Executive Board of the ECB, Egon and Joan von Kashnitz Lecture, Clausen Center for International Business and Policy, Berkeley, 21 November 2015.

⁴ See Caballero, J. A. (2014), “Do surges in international capital inflows influence the likelihood of banking crises?” *Economic Journal*.

⁵ See Borio, C., E. Kharroubi, C. Upper and F. Zampolli (2016), “Financial cycles, labour misallocation, and economic stagnation”, BIS Working Paper 534. Benigno, G., N. Converse, and L. Fornaro (2015), “Large capital inflows, sectoral allocation, and economic performance”, *Journal of International Money and Finance*, volume 55, pp. 60–87.

⁶ See Obstfeld, M. (2010), “Expanding gross asset positions and the international monetary system,” *Proceedings – Economic Policy Symposium – Jackson Hole*, Federal Reserve Bank of Kansas City, pp. 463-478.

⁷ See Kose, M. A., Prasad, E., Rogoff, K. and Wei, S.-J. (2009), “Financial Globalization: A Reappraisal”, *IMF Staff Papers*, vol. 56(1).

⁸ See Cerrutti, E., S. Claessens and D. Puy (2015), “Push Factors and Capital Flows to Emerging Markets: Why Knowing Your Lender Matters More Than Fundamentals”, *IMF Working Paper 15/127*.

⁹ See Kose et al. (2009), *op. cit.*

gross, rather than net, international financial flows and positions are crucial for the assessment of financial stability.¹⁰

In particular, financial actors engage in maturity and liquidity transformation within different currencies, regardless of their home lender of last resort, and this opens the door to financial fragility.¹¹

The backlash against financial globalisation

The challenges posed by financial globalisation and revealed first by regional economic crises in parts of the emerging world, and then by the global financial crisis, have been met by various policy responses. These include the use of so-called capital flow management measures (CFMs), as well as other “hidden” barriers related to regulatory policies.

In the aftermath of the global financial crisis, a new international consensus on the use of CFMs has emerged. This new view is more open to acknowledging potential benefits of temporary capital flow restrictions.¹²

In particular, in circumstances of large and volatile capital flows it may be admissible and more effective to complement appropriate monetary, exchange rate, and prudential policies by temporary and well-targeted CFMs.¹³

But many of the barriers to global capital flows are more indirect and hidden. The build-up of systemic risk on- and off-the-balance-sheet of regulated (and unregulated) intermediaries resulted in a widespread adoption of macro-prudential policies. Certain of these measures have negative side effects on capital flows including: regulatory ring-fencing, currency-based measures, financial repression policies, crisis resolution policies with a national bias, and some financial sector taxes.¹⁴

These barriers, together with the actual or perceived cost of AML/CFT enforcement actions, have led to a retrenchment of cross-border banking flows, evidenced inter alia by the shrinking correspondent banking relationships network.¹⁵

¹⁰ See Lane, P. (2013), “Financial Globalisation and the Crisis,” *Open Economies Review* 24(3), 555–580, July 2013.

¹¹ See Bruno, V. and H.S. Shin (2015), “Cross Border Banking and Global Liquidity”, *Review of Economic Studies*, vol 82, no 2; Obstfeld, M. (2012). “Does the Current Account Still Matter?” *American Economic Review*, 102(3): 1–23; Borio, C. (2015), “On the centrality of the current account in international economics”, Keynote speech at the ECB-Central Bank of Turkey conference “Balanced and sustainable growth-operationalising the G20 framework”, Frankfurt, 28 August 2015.

¹² See G-20 Coherent Conclusions for the Management of Capital Flows, October 2011, available at <http://www.g20.utoronto.ca/2011/2011-finance-capital-flows-111015-en.pdf> and International Monetary Fund (2012), “The Liberalization and Management of Capital Flows: An Institutional View”, November.

¹³ For an assessment of the effectiveness of CFMs, see Forbes, K, Fratzscher, M. and R. Straub (2015), “Capital-flow management measures: What are they good for?”, *Journal of International Economics*, Elsevier, vol. 96(S1), pages S76-S97. With respect to international spillovers of CMFs, see Forbes, Kristin & Fratzscher, Marcel & Kostka, Thomas & Straub, Roland, 2016. “Bubble thy neighbour: Portfolio effects and externalities from capital controls,” *Journal of International Economics*, Elsevier, vol. 99(C), pages 85–104. With respect to domestic distortions created by capital controls, see e.g. Forbes, Kristin J., 2007. “One cost of the Chilean capital controls: Increased financial constraints for smaller traded firms,” *Journal of International Economics*, Elsevier, vol. 71(2), pages 294–323, April.

¹⁴ See Beck, R. J. Beirne, F. Paternò, J. Peeters, J. Ramos-Tallada, D. Reinhardt, L. Weissenseel and J. Wörz (2015), “The side effects of national financial sector policies: Framing the debate on financial protectionism”, ECB Occasional Paper No. 166.

¹⁵ See Lagarde, C., “Relations in banking: Making it work for everyone”, speech at the New York Fed, 18 July 2016, and Committee on Payments and Market Infrastructures, “Correspondent Banking”, Bank for International Settlements, July 2016.

Indeed, our current version of financial globalisation comes with a number of adverse side effects for the financial sectors of both home and host countries of capital flows. And therefore, some of the imposed policy measures are justified and have reduced systemic risk.

But the general backlash against financial globalisation carries the risk of significantly impairing the efficient functioning of the economy at global, regional and national levels, which make it particularly worrisome. The answer, I believe, is not to put the break on financial globalisation, but transform it by aiming for a higher quality version of it, which for the purpose of this speech I will call financial globalisation 2.0.

Financial globalisation 2.0

There are many elements to successfully implementing financial globalisation 2.0, but I would like to highlight three of them.

First, policymakers need to ensure capital flows are used *efficiently* where they are most productive.

Second, they need to incentivise state-contingent capital flows so that financial globalisation is *enduring* and less susceptible to short-term volatility.

Finally, they need to address the distributional impacts of financial globalisation, by reducing international spillovers across countries and mitigating asymmetric impacts within countries so that the benefits are *equitably* shared by everyone.

Let me now elaborate on each of these three dimensions.

The *first stage* is to put far greater emphasis on improving countries' absorptive capacity. Financial globalisation should be underpinned with institutional, regulatory and structural reforms that strengthen domestic financial markets, improve their resilience and increase their capacity to efficiently allocate funds to productive uses. Investment in infrastructure and education and structural reforms to promote flexible product and labour markets all increase flexibility in the economy, improving absorption.

This is not a new theme: it was recognised in the wake of the Asian financial crisis that financial openness had to observe the right sequencing, starting with stronger domestic financial systems.¹⁶

But evidence has accumulated and it is now clear that a threshold of institutional development is required in order to allocate incoming flows to productive investment projects.¹⁷

Given the already close financial integration between member states of the European Union, increased absorptive capacity is vital. In the euro area, in particular, structural reforms, required to support growth and enhance growth potential, will only succeed if capital is reallocated to the most productive sectors.¹⁸ A similar reasoning applies at the global level, with the difference that institutional frameworks can be improved *before* the financial account is liberalised.

¹⁶ See Obstfeld, M., and Taylor, A. *Global Capital Markets – Integration, Crisis, and Growth*. Cambridge University Press, 2004.

¹⁷ See Kose, A., Prasad, E. and Taylor, A. (2011), "Thresholds in the process of international financial integration," *Journal of International Money and Finance*, 30(1), pp. 147–179.

¹⁸ See Cœuré, B., "Structural reforms: Learning the right lessons from the crisis", speech at the Latvijas Banka Economic Conference, Riga, 17 October 2014.

One key element of the necessary institutional framework is legal certainty. An efficient intermediation of foreign savings into productive domestic uses can only occur with a proper and enforceable legal framework in place. In the case of banks, the latter should include reliable legal frameworks for corporate insolvency and for the resolution of non-performing loans (NPLs) which hold down credit growth and economic activity, in particular in Europe.¹⁹

With more resilient institutional arrangements in place, the *second step* is to improve the quality of capital flows. Their composition should be tilted away from short-term debt flows towards more enduring longer-term and state-contingent flows. The predominance of easily reversible short-term debt flows in the current context is an equilibrium outcome driven by the risk and return perceptions of independent economic agents.²⁰

Specifically, investors favour flows that can be quickly reversed where they perceive there to be inadequate financial regulation, weak rule of law and property rights. The euro area crisis has also shown the dangers of a financial integration model based on short-term cross border interbank flows rather than longer-term lending or equity investment, which has led capital to be allocated to low-productivity sectors and sown the seeds of financial instability.

But what does tilting the composition towards state-contingent, loss absorbing flows mean in practice? Do we just mean more equity investments or should we also promote innovative state-contingent sovereign debt instruments such as GDP-linked bonds?²¹

Such instruments have to date rarely been used in practice – only as part of a debt-restructuring mechanism and some limited issuance of catastrophe bonds. We know little as yet at what prices such instruments could be traded in the market place, and whether the underlying index can be robust enough to create investor trust, as is the case with inflation-linked bonds. To gain such an experience, international financial institutions could play a catalytic role, as potential issuers of GDP-linked bonds.²²

At the same time, we should carefully reflect upon the trade-offs created by loss-absorbing instruments.

First, they might create a conflict between ex-ante and ex-post incentives. Loss-absorbing instruments, while protecting taxpayers and providing the right incentives to investors, might lead to unexpected distributive consequences depending on which investors are ultimately holding these instruments.

Second, issuing more state-contingent liabilities rather than traditional debt instruments might exacerbate the shortage of global safe assets. There is already an excess demand for highly liquid, non-state contingent assets driven in particular by regulatory restrictions, and a rise in risk aversion. A further reduction of their supply can be particularly problematic in an environment in which interest rates are already structurally low and further depressed by a high demand for safe assets.²³

¹⁹ See Aiyar, S., W. Bergthaler, J. Garrido, A. Ilyina, A. Jobst, K Kang, D. Kovtun, Y. Liu, D. Monaghan and M. Moretti (2015) “A strategy for resolving Europe’s problem loans”, IMF Staff Discussion Note No 15/19, International Monetary Fund, and European Central Bank, “Draft guidance to banks on non-performing loans”, September 2016.

²⁰ See Tirole, J. (2006), “The Theory of Corporate Finance”, Princeton, NJ: Princeton University Press.

²¹ See Blanchard, O., P. Mauro and J. Acalin (2016), “The Case for Growth-Indexed Bonds in the Advanced Economies Today”, Policy Brief No, Peterson Institute for International Economics.

²² See Griffith-Jones, S. and D. Hertova (2013), “Growth-linked Bonds”, CESifo DICE Report 3 33 /2013 (September).

²³ See Caballero, R J, E Farhi, and P-O Gourinchas (2015), “Global Imbalances and Currency Wars at the ZLB”, mimeo, October.

Let me underline also that, the first two elements necessary to upgrade financial globalisation complement each other. Improvements with respect to corporate governance, the overall quality of the institutional framework and transparency are likely to be helpful in encouraging longer-term flows.²⁴

In Europe, where more cross-border equity investments are not only desirable from a financial integration but also from a financial development point of view, capital markets union will help achieving these objectives.²⁵

The *third element* in a successful upgrade to financial globalisation 2.0 is to ensure that the benefits are equitably distributed, both across and within countries. The introduction of CFMs represents a push-back against cross-country spillovers caused by financial globalisation. For a recent clear example, consider the impact of the 2013 “taper tantrum”, where perceptions of changes in the Federal Reserve’s monetary policy had a marked impact in emerging market economies. Improving the absorptive capacity of these economies and tilting the composition of capital inflows will mitigate these spillovers. But we may need to move towards a regime of greater international cooperation and policy alignment to mitigate the externalities triggered by national policies. The IMF’s search for a wider span of the Global Financial Safety Net can be seen as an effort in this direction.

There are also distributional impacts within countries that need to be better addressed. There is a direct parallel here with the debate on trade openness. While the academic literature is more favourable in its assessment of the benefits of trade than for financial globalisation, it also stresses the distributional implications of trade openness. Ideally, the gains of trade globalisation are redistributed by taxation from those made better off to those made worse off. But the current public scepticism, if not outright hostility, towards free trade agreements and the surge in trade restrictions documented by the WTO²⁶ suggests that that such redistribution is not effective, if at all achieved.

Indeed, trade openness and financial globalisation are interconnected. Financial globalisation has made it increasingly easy for multinational corporates to shift their profits to low-tax countries and for wealthy individuals to move funds to undeclared bank accounts in offshore tax havens.²⁷

This tax avoidance facilitated by financial globalisation has reduced government tax bases worldwide and limited their ability to redistribute the gains from trade integration.

We need to think of ways to co-ordinate better to ensure that the benefits from trade and financial globalisation ultimately accrue to everyone. And working together at the European and at the global level is still the best way to solve the new challenges we face.²⁸

The popular disenchantment with trade and financial globalisation will not be overturned until governments cooperate better, and it is now quite apparent that such cooperation will not be a loss of sovereignty but will allow them to *regain* sovereignty over their ability to redistribute wealth equitably. The European Commission’s action plan on fair and efficient corporate tax system in the European Union and investigation into undue tax benefits are steps in this

²⁴ See e.g. Anginer, Deniz, Asli Demirgüç-Kunt, Vojislav Maksimovic, and Mete Tepe (2015), “Is Short-Term Debt a Substitute or a Complement to Good Governance?” Chapter 2 in “Global Financial Development Report 2015/16,” World Bank, Washington, DC.

²⁵ See European Central Bank (2016), “Financial Integration in Europe”, April, Frankfurt.

²⁶ World Trade Organisation, Report on G20 trade measures, 21 June 2016.

²⁷ See Zucman, G. (2014), “Taxing across Borders: Tracking Personal Wealth and Corporate Profits”, Journal of Economic Perspectives, vol. 28(4), pp. 121–148.

²⁸ See Draghi, M., “Reviving the spirit of De Gasperi: working together for an effective and inclusive Union”, speech by Mario Draghi, President of the ECB, at the presentation ceremony of the De Gasperi award, Trento, 13 September 2016. <http://www.ecb.europa.eu/press/key/date/2016/html/sp160913.en.html>.

direction.²⁹ At the global level, similar efforts are taking place with the action plans on base erosion and profit shifting (BEPS) initiated by the OECD.³⁰

Conclusion

The question we face today is how financial globalisation should evolve, and whether we should seek to limit it. Because globalisation has evolved to date in a way that has let underlying risks build up and erupt in crises, economic openness has come at the expense of safety. Quite naturally, public opinion is now ready to trade one against the other, and accept less openness for what they believe will make their jobs and income safer. The time has come to make the case that financial globalisation can be made more efficient, enduring and equitable so that it can deliver openness without compromising safety – and to implement it in a convincing way.

²⁹ See https://ec.europa.eu/taxation_customs/sites/taxation/files/docs/body/com_2015_302_en.pdf.

³⁰ See <http://www.oecd.org/ctp/beeps-2015-final-reports.htm>.