José Manuel González-Páramo: Globalisation, macroeconomic stability and monetary policy at a time of financial turmoil

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the FCAVN Seminar on "Globalisation in the XXI Century: Challenges and Dilemmas", San Sebastián, 5 September 2008.

* * *

1. Introduction

Ladies and Gentlemen,

It is a great pleasure for me to be here in San Sebastián and I would like to thank the organisers – Federación de Cajas de Ahorros Vasco-Navarras and, in particular Mr Pedro Martínez de Alegría Pinedo – for giving me the opportunity to participate in this Seminar, which continues what is by now a long tradition started in 1991.

Like in the past, the organisers have challenged us by choosing a very important but rather "difficult" subject: the challenges and dilemmas that the financial globalisation process poses for policy-makers, economic agents and the society at large.

Financial globalisation has potentially very significant implications for the welfare of our economies, as the experience of the turmoil in international financial markets over the last year shows. It is therefore very important that we improve our understanding of how financial globalisation is changing the structure of our economies and the way they work. Therefore, we should congratulate the organisers for promoting a public debate on this issue. In my intervention today, I will focus on the relationship between financial globalisation and the market turmoil that we have experienced since last year, and some of the lessons that we have learned.

I would also like to use this opportunity to share with you some considerations about the euro area economy. Therefore, in my intervention I will briefly discuss the state and the outlook for economic growth and inflation in the euro area and their implications for monetary policy.

2. Different dimensions of globalisation

Globalisation is a catch-all term used to describe the growing interdependence of the international economy via trade, production and financial market linkages over recent decades. A number of key indicators of globalisation compiled by academic researchers and international organisations (e.g. the size of international capital markets, portfolio investment and FDI, trade openness, international competition, etc.) show that the current wave of globalisation gained momentum at around the beginning of the 1980s and significantly accelerated in the course of the 1990s.[1]

Understanding globalisation is very important for central banks since globalisation may – via a number of channels – affect key elements of the monetary policy framework, such as the inflation formation process and the monetary transmission mechanism.[2] In particular, changes in the structure and workings of the economy prompted by globalisation may alter

[1] For a review of issues related to financial globalisation see BIS (2006), "Financial globalisation", BIS Paper N. 32, December.

[2] See Ciccarelli, M. and Mojon, B. (2005), "Global inflation", European Central Bank Working Paper No. 537.

the relative importance of the various transmission channels of monetary policy impulses.[3] This is indeed one of the major *challenges* posed by globalisation, to recall the theme of this seminar.

The theme of the seminar is also the *dilemmas* arising from globalisation. The President of the Federal Reserve Bank of Dallas, Richard Fisher, once remarked that *"One cannot make monetary policy without being aware of the forces of globalization acting upon our economy".*[4] Yet, we still know relatively little about how globalisation has affected our economies. This is partly because the current wave of globalisation is still fairly new. Thus, its impact on the structure of the economy may yet to emerge in the data or may be hard to discern using analytical tools, such as econometric models, based on regularities drawn from the study of a less globalised world. Besides, over the last few decades, our economies have also undergone other structural changes (for instance, in the monetary policy regime) that may render it difficult to disentangle the specific effect of globalisation from those of changes elsewhere in the economy.

At the same time, even in a globalised world, inflation remains a monetary phenomenon in the long run and central banks retain their key role and responsibility in preserving price stability. If anything, the commitment of central banks to price stability becomes even more necessary since a solid anchoring of inflation expectations at levels consistent with price stability is essential in a rapidly changing global economy, where inflation dynamics can be affected in various ways and adverse shocks are more easily and rapidly transmitted across countries.

One of the main sources of changes to the global economy during the current wave of globalisation has been the acceleration in financial integration across countries, particularly since the second half of the 1990s. While some researchers often point out that the current level of openness of international capital markets is still lower than that prevailing before World War I, there is no doubt that we live in a world in which advances in financial and communications technology combined with regulatory and institutional changes have led to international capital markets and financial institutions becoming more closely interrelated than ever in the past.[5]

Growing financial integration among countries and regional areas is a potential source of benefits, notably due to enhanced opportunities for international risk sharing. Indeed, financial globalisation may provide countries with instruments to hedge against idiosyncratic shocks in order to better smooth consumption smoothing, thereby yielding significant welfare gains. In addition, larger integration into the international financial system may contribute to the efficient functioning of the entire economy by providing additional financing at a reasonable cost to domestic agents, by facilitating the transfer of technology from abroad and by stimulating the performance of the domestic financial sector.

However, financial globalisation may also entail some risks. Increased international financial integration is likely to lead to a larger sensitivity to external spillovers. Under more extreme circumstances, the experience of some developing countries suggests that increased integration into international financial system, if not accompanied by the establishment of high-quality institutional and regulatory frameworks as well as sound macroeconomic policies, may make countries more vulnerable to episodes of financial and macroeconomic instability.

---

[3] See González-Páramo, J.M. (2007) “Globalisation and monetary policy”, Lecture at Suomen Pankki, Helsinski, 15 March (http://www.ecb.europa.eu/press/key/date/2007/html/sp070316.en.html).

[4] Fisher, R.W. (2005). "Globalization and monetary policy", Warren and Anita Manshel lecture in American foreign policy, Harvard University, 3 November.

[5] See for instance Stanley Fischer’s analysis in BIS (2006), *cit.*

3. The financial turmoil

The episode of financial market turmoil that we have experienced since August 2007 provides a good illustration of how, in a globalised economy, an idiosyncratic shock can be propagated more rapidly and through a variety of new channels to seemingly distant countries and markets. Indeed, the turmoil originated in a relatively small segment of the US economy – the sub-prime segment of the mortgage market – that has no obvious relationship with the Eurosystem's sphere of interest. Yet, its quick propagation caused an increase in volatility and a decline in liquidity in a variety of markets all around the world, including the euro area market for inter-bank unsecured loans that represents a key component of the money market and the starting point of the area-wide monetary transmission mechanism.

The decrease in liquidity was most obvious for the markets directly related to the core of the current turmoil, namely the market for sub-prime mortgage-backed securities (MBSs). However, since the start of the turmoil problems of illiquidity have spread further, affecting other asset-backed securities (ABSs), asset-backed commercial paper (ABCP), and basically all structured credit instruments, such as collateralised debt obligations (CDOs). Also the liquidity in the secured non-government repurchase agreement (repo) markets was heavily impacted, as many banks no longer wanted to accept the types of securities mentioned above (MBSs, ABSs at large, and CDOs) as underlying collateral in repo transactions. Another market segment that saw a partial (temporarily, even severe) deterioration of liquidity conditions is the foreign exchange swap market, which is very important for banks managing liquidity in different currencies. Occasionally, poor liquidity conditions have been reported even in markets for securities historically regarded as very liquid and safe, such as the market for bank covered bonds or, even, the government bonds of some developed economies.

To understand, at least partly, how the disturbances in a fairly domestic-oriented part of the US economy – a small segment of its housing market – could have spread across borders, financial markets and institutions all around the world, we must bear in mind the increasing importance of credit securitisation and the emergence of credit derivatives in global financial markets. Credit securitisation essentially means to convert highly illiquid loans into liquid and tradable securities that can be sold to investors. While the origination of bank loans remains to a large extent level, financial globalisation has made the related securities available to investors worldwide.

Some scholars have nevertheless challenged the recurrent claim that the current turmoil is unprecedented.[6] Indeed, past financial disturbances and crises have often had an international dimension and cross-border financial contagion is certainly "no new thing under the sun". However, a number of factors, including its speed of transmission and scope, set the current episode of turmoil apart from previous experiences.

4. Policy responses

Let me briefly elaborate on the actions taken by the ECB to address the financial market turbulences. In both "normal" and "turbulent" times, the primary objective of the Eurosystem's open market operations is to keep the overnight rate as close as possible to the policy rate. However, during the recent period of turbulence, open market operations have aimed also at ensuring the continued access of solvent banks to liquidity, notably by contributing to smoothening the impaired functioning of the money market. By doing so, the ECB has intended to contribute to re-establishing confidence among market participants and to

---

[6] See Bordo, M. (2007), "The crisis of 2007: The same old story, only the players have changed", Remarks prepared for the Fed Chicago and IMF Conference on Globalisation and Systemic Risk.

safeguarding financial stability and the appropriate functioning of the monetary policy transmission mechanism.

From the very first day of the financial market turmoil, in an environment of increased liquidity risk and in response to banks' changed liquidity demand pattern, the ECB has achieved these objectives in two different ways.

First, the Eurosystem has adjusted the distribution of liquidity supplied over the course of the maintenance period, by frontloading the supply of liquidity at the beginning of the period and reducing it later, so that the total amount of liquidity over an entire maintenance period has remained unchanged.

Second, during the turmoil the Eurosystem has applied different open market procedures to supply liquidity to the banking system. More specifically, the use of fine-tuning operations has been more frequent than in "normal times" because of the unpredictability of liquidity demand. In addition, the amount of refinancing provided via longer-term refinancing operations with 3-month duration and, since April 2008, also with 6-month maturity has increased significantly with a view to maintaining smooth conditions in the term money market. At the same time, the amount of refinancing provided via the one-week main refinancing operations has been reduced correspondingly, so that the total amount of outstanding refinancing has remained unchanged.

Given the global nature of the financial turmoil, central banks have strengthened their cooperation, first through enhanced information exchange and collective monitoring of market developments and later on by coordinated steps to provide liquidity. Since December 2007, the ECB has, in cooperation with the US Federal Reserve and together with the Swiss National Bank, been conducting several term auction facilities – the so-called TAF-operations – to provide USD liquidity to euro area banks. In practice, through these operations the ECB grants loans in USD to euro area banks, on behalf of the US Fed, with a maturity of 28 days and, since August 2008, also of 84 days. These liquidity-providing operations do not have a direct effect on euro liquidity conditions, but are conducted to address the availability of US dollar funding for euro area banks and aim at improving global funding conditions.

As regards other central banks, in general their primary response to the market turmoil has been to intervene to keep short-term money market rates near target rates, through more active liquidity management. Moreover, central banks have aimed to ease the increasing pressure in term money markets by: (1) increasing the viability of standing loan facilities as backstop funding options; (2) boosting the share of longer-term operations in total refinancing provided to banks; (3) expanding the range of acceptable collateral and eligible counterparties, in those countries where it was needed; and (4) establishing security lending facilities.[7]

4. Lessons from the turmoil

Whilst it is too early to make a definitive assessment, certain supervisory, regulatory and operational issues can already be identified as warranting further attention or action. Initiatives are already underway at the international and EU level to address these various issues. Let me highlight some of them.

4.1 Lessons for supervisors and regulators

The recent episode of financial turmoil has reminded us that financial globalisation makes the safeguarding of financial stability a more interdependent task, requiring effective coordinated international action aimed at addressing financial system vulnerabilities.

---

[7] See CGFS Study Group, "Central bank operations in response to the financial turmoil", CGFS Paper 31.

Against this background, both the public and the private sector have undertaken a major collective effort to identify measures needed to strengthen the resilience of the domestic and international financial systems in the longer term in order to avoid the recurrence of similar events in the future.

Particularly important in this respect is the report of the Financial Stability Forum (FSF) on "Enhancing Market and Institutional Resilience" that has been fully endorsed by the international community and acts as the main reference for the necessary improvements. In this context, let me briefly recall some of the key areas in which the report has identified room for improvement: (i) some aspects of the prudential framework, relating to capital and liquidity risk as well as to banks' liquidity risk management practices; (ii) transparency, including full disclosure of banks' exposures on structured products and off-balance sheet vehicles; (iii) valuation standards, especially as regards marking-to-market illiquid assets; (iv) market functioning, including possible conflicts of interest of credit rating agencies and their role in rating structured finance instruments; and (v) authorities' responsiveness to risks and arrangements for crisis management.

Having identified the main areas for intervention, the key issue is now to ensure the rapid and effective implementation of the respective recommendations in the FSF report. In particular, the short-term measures put forward by the FSF and endorsed by the G7 in April this year represent immediate priorities and thus a time horizon of 100 days for their implementation has been set. While a more thorough review of the progress in the implementation of these recommendations is due for the G7 meeting in October, the results of a preliminary assessment is encouraging. Indeed, progress has been observed in a number of areas identified as requiring immediate action.

In addition, the recent market correction has exposed a number of more structural weaknesses of the financial system that represent medium-term priorities for policy work. Some of the topics of critical importance from a central banking perspective include: (1) to ensure adequate transparency regarding financial markets, institutions and financial instruments; (2) the effective and timely implementation of the new Basel II framework, after revising detected shortcomings (for instance related to any pro-cyclical features of the regulatory framework); (3) the growing importance and complexity of liquidity risk in more market-based financial systems; (4) the enhancement of institutional arrangements for cross-border cooperation among authorities, both at times of financial stress and in normal times.

Finally, I would like to highlight the importance of improving cooperation and the exchange of information between supervisory authorities and central banks on financial stability issues. The recent financial market turmoil has confirmed the importance of a smooth and efficient relationship between the central banking and supervisory functions. In financial stress situations, supervisory information remains essential for the effectiveness of the central bank's financial stability assessments. Conversely, supervisors should benefit from the systemic perspective of central banks when considering their actions vis-à-vis individual institutions. This is the rationale behind the specific FSF recommendation to enhance the interplay between central banks and supervisory authorities.

4.2 Lessons for the operational frameworks

The ability of the Eurosystem to respond to the challenges for monetary policy implementation posed by the recent period of financial market volatility has to a large extent depended on its collateral framework. Thanks to the broad range of assets eligible as collateral – together with the large number of counterparties and the large size of its refinancing operations – the Eurosystem has been able to step in effectively when intermediation in inter-bank markets deteriorated, without the need to make changes to its framework.

As a side effect of the broad range of assets accepted as collateral, the framework helped us also during the turmoil to address liquidity squeezes in some markets, including the ABS

market, as it mitigated refinancing risks for asset classes that had become illiquid. This has contributed to financial stability in the euro area. Other central banks may have had those effects in mind when they initiated changes to their operational framework in the wake of the turmoil, leading to a significant degree of convergence among the various frameworks.

Of course, the ability of the Eurosystem's operational framework to respond to the challenges for monetary policy implementation posed by the recent period of financial market volatility does not mean that there is no scope for further improvements and refinements to make it even more effective. Regarding this point, the ECB yesterday announced some technical refinements to its risk control framework for Eurosystem credit operations. These are the result of a regular review of the framework, conducted on a biennial basis with the objective of identifying possible improvements and ensuring that the Eurosystem remains adequately protected against financial risks in the face of changes in financial markets and collateral use practices.

The announced refinements are as follows:

First, some revisions are being introduced to the haircuts for credit institution debt instruments and asset-backed securities. The first are increased by 5%, across all maturities, while the haircut schedule for ABS is replaced by a unique haircut of 12% for all maturities and coupon types. In addition, a valuation markdown of 5% is imposed on those ABS that are priced theoretically.

Second, the ECB has extended the definition of "close links" between counterparty and collateral. As you may know, the existence of such links, which are currently defined only in terms of cross ownership of capital, would prevent a counterparty from using that collateral. With the announced change, "close links", are extended to situations in which a counterparty submits an ABS as collateral when it provides support to that ABS. Such support should not be in the form of extensive liquidity support or in the form of a currency hedge.

Finally, we have placed more weight on the transparency of the credit assessments by ratings agencies. Such assessments should be based on a public rating and, for ABSs, publicly available credit-rating reports and quarterly rating reviews would be required.

These changes were deemed necessary as they reflect improvements in the methodological framework, the assessment of market and liquidity risk characteristics of eligible assets, the actual use of eligible assets by counterparties, and new developments in financial instruments.

5. Monetary policy

The continuation of the financial market turbulences has increased the uncertainty surrounding not only the implementation of monetary policy but also its formulation. Let me now turn to our current assessment of the monetary policy stance. I should start by stressing that, also in an increasingly globalised world, inflation is fundamentally and over the long term a monetary phenomenon. Despite the many challenges which we face daily, euro area monetary policy must remain focused on delivering price stability in the medium term, which is essential for the efficient working of markets and the optimal allocation of resources.

Looking at the current inflation performance, there is no reason to be satisfied. Annual HICP inflation has remained well above levels consistent with price stability since last autumn. This is largely due to both the direct and the indirect effects of the sharp increases in commodity prices, particularly oil and food prices, observed in recent quarters.

The inflation outlook is also a source of major concern. HICP inflation is expected to remain above levels consistent with the ECB's quantitative definition of price stability for a rather protracted period of time, and to moderate only in the course of next year. Consistent with this outlook, the latest ECB Staff projections, released yesterday, show that annual HICP inflation is expected to average between 3.4% and 3.6% in 2008, and between 2.3% and

2.9% next year. Projections from international organisations and private sector forecasters depict a similar picture.

At our meeting yesterday, the members of the Governing Council concurred that risks to price stability at the policy-relevant horizon remain on the upside. These risks mainly relate to possible further increases in commodity prices or to the delayed effects of past price increases. Besides, the possible emergence of broad-based second-round effects in price and wage setting behaviour represents a source of acute concern. In addition, unanticipated increases in indirect taxes and administered prices may aggravate the outlook for inflation.

In the current context of strong inflationary pressures, it is essential to maintain longer-term inflation expectations solidly anchored at levels consistent with price stability and to avoid that the current inflation rates become entrenched in private sector inflation expectations. This is not only the task of the central bank. All parties, in both the private and the public sector, can give a key contribution to maintaining price stability by abstaining from any practices that may fuel broad-based second-round effects. In this sense, it is particularly important that all parties concerned agree to abolish indexation schemes for nominal wages in those countries where they still exist. Under the illusory pretence of preserving the purchasing power of workers, these schemes risk turning temporary price shocks into devastating inflationary wage-price spirals that ultimately undermine employment and competitiveness to the detriment of those whom the schemes are supposed to protect.

Let me also briefly recall the Governing Council's current assessment of economic activity in the euro area. The latest data indicate that, after recording a 0.2% decline on a quarterly basis in the second quarter of 2008, the euro area economy is currently experiencing a period of weak activity, reflecting the dampening impact of both domestic and external factors. Nevertheless, we expect the current episode of weakness to be followed by a period of gradual recovery. Consistent with this scenario, the ECB Staff projects average real GDP growth to between 1.1% and 1.7% in 2008, and between 0.6% and 1.8% next year.

However, the uncertainty surrounding the outlook for growth in 2008 and 2009 is particularly high, with risks predominantly on the downside. These downside risks mainly stem from further unanticipated increases in energy and food prices, the continuing possibility that the financial turmoil may have a more severe impact on the real economy than currently anticipated, the potential for disorderly developments stemming from persisting global imbalances and increasing protectionist pressures.

The monetary analysis has continued to confirm our view of prevailing upside risks to price stability at medium to longer horizons. Although the growth of euro area broad monetary and credit aggregates has recently moderated, the continued underlying strength of monetary expansion signals the existence of upside risks to price stability over the medium term.

On the basis of its economic and monetary analyses, the Governing Council decided yesterday to leave the ECB's key policy rate (the minimum bid rate of its main refinancing operations) unchanged at 4.25%. It is our view that the current monetary policy stance will contribute to achieving our primary objective of maintaining price stability in the medium term.

The public at large should be confident that the members of the Governing Council are resolutely determined to do whatever it will be necessary to fulfil the ECB's mandate of delivering price stability in the medium term and to maintain expectations firmly anchored at levels consistent with price stability. This is the best contribution that the ECB can provide in order to preserve the purchasing power of citizens over the medium term and to support sustainable growth and employment in the euro area.

Many thanks for your attention.