Financial Globalisation – Why, How, and When?

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Introduction

- Let me first thank the BIS for its excellent arrangements and warm hospitality.

- I want to cover three broad areas in my remarks and, in doing so, at least partly address the questions that Jaime Caruana has posed us:

    - First, I will revisit the costs and benefits of financial globalisation.

    - Second, I will touch on the role that financial deepening and financial globalisation – and I want to make a distinction between these two – play in Asia's economic rebalancing and restructuring.

    - Third, I will offer some thoughts on what needs to be in place before proceeding with financial globalisation.

Re-Thinking Financial Globalisation

- ***Financial globalisation has two main aspects:***

    - ***Free flow of capital into and out of the domestic economy***
    - ***High foreign participation in domestic financial system***

- Both aspects can be measured in many ways:

  - Capital mobility: holdings of cross-border financial assets and liabilities, magnitude of cross-border flows into and out of the financial system.

  - Foreign participation: foreign share of domestic banking assets and liabilities, ease of entry for foreign financial institutions into domestic market.

- ***Financial globalisation along both dimensions, if well managed, can yield benefits for the economy.***

  - The purported benefits of <u>open capital markets</u> are well-known, even if there is controversy around the significance of these benefits. For EMEs, the strongest benefit is the access that it provides to international capital.

  - As for <u>openness to foreign financial institutions</u>, they play a critical function in credit intermediation, and maturity and risk transformation across national borders. They promote competition and innovation and introduce new technologies and best practices.

- I come from a country that has benefitted significantly from financial globalisation. But Singapore's experience cannot be generalised.

- ***For most EMEs, financial globalisation is not costless and its benefits are not compelling.***

- Let's consider <u>capital mobility</u> first. There have been second thoughts about benefits of unfettered capital flows.

  - Financial openness in itself does not cause crisis. John Taylor rightly reminded us yesterday that inappropriate monetary policies played a big part in causing financial crises. Alan Taylor made a strong case for excessive credit expansion as a key causal factor.

- But financial globalisation is the channel through which crisis contagion takes place. It raises risk of spillovers. Periodic transmission of financial crises tends to roll back benefits from greater financial globalisation

- Well-known research from Carmen Reinhart and Kenneth Rogoff suggest a positive correlation between banking crises and cross-border capital mobility. This is due in part to the procyclical nature of financial markets.[1]

- Maurice Obstfeld takes the view that globalisation has gone too far, noting that *"existing informational and institutional structure for global policymaking remains woefully inadequate to the challenge of financial globalisation."*[2]

    - Dani Rodrik's comments yesterday alluded to this. Crisis contagion is so disruptive because we lack a system of international deposit guarantees and a global regime for bankruptcy and resolution.

    - International trade has a WTO to set and enforce the rules of the game. International finance does not.

    - So there is some truth in Rodrik's gun control analogy. Precisely because we cannot be sure that policies elsewhere will be appropriate, we need to be cautious about how open we are to channels through which effects of bad polices abroad are transmitted to domestic financial system.

- So much for capital mobility. What about <u>foreign participation</u> in the domestic financial system?

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[1] Reinhart, C & Rogoff, K (2009), "This Time is Different: Eight Centuries of Financial Folly," Princeton University Press.

[2] Obstfeld, M (2011), "Financial flows, financial crises, and global imbalances," Keynote Address to the 15th International Conference on Macroeconomic Analysis and International Finance, University of Crete, Greece, May.

- For reasons I highlighted earlier, basic direction should be towards opening up financial sector, allowing for the presence of global players in domestic markets, but also putting in place appropriate financial stability safeguards.

  - Many of these safeguards are well-known and universally accepted – sound regulation and rigorous supervision of financial institutions, having in place adequate capital and liquidity buffers, and improving transparency and corporate governance.

  - But I want to touch on two additional areas where more thought is required.

- ***First, to what extent should foreign banks be allowed to take deposits, especially retail deposits, and especially through branches?***

  - The universal branching model where branches of foreign banks are permitted to undertake a combination of retail, commercial and investment banking activities without a need to legally separate these activities, has significant efficiency benefits for banks.

  - It allows them to take advantage of economies of scale by sharing management resources and capital across its business lines, and pool risks across the banking group globally.

  - For commercial and investment banking business, financial globalisation generally works well.

- But when foreign bank branches have a significant share of domestic retail deposits, financial globalisation can be risky.

  - During periods of severe stress, the provision of essential services by a branch – especially to retail customers – could be disrupted.

  - Local retail depositors would be exposed to possible contagion or a crisis of confidence arising from problems in the bank's home market.

- There is, therefore, a case for additional safeguards for retail deposit taking by foreign banks – through limits on branching privileges or imposing local incorporation requirements.

- ***Second, to what extent should financial openness be limited by the prudential need for strong domestically anchored banks, whose interests are aligned with those of the domestic economy?***

- There is a proposition that banks with long-term interests aligned with the domestic economy will be more likely to act in support of the country's financial and economic stability.

- In a crisis, strong, domestically anchored banks may be needed to undertake various roles.

  - First, they may be needed to acquire distressed financial institutions whose failure could have a systemic impact. The 2008 crisis provides some examples of this. In the US, Bank of America took over Merrill Lynch, and JP Morgan took over Bear Stearns. And in the UK, Lloyds took over HBOS.

  - Second, strong and anchored banks may be needed to increase their role as key credit intermediaries in a crisis. This may include collaborating with the government to sustain lending to businesses in the real economy, where a credit freeze could result in business failures, job losses, and a more severe downturn.

- To be clear, I am not advocating the protection of local banks and the building of local champions. My point is that we need to think hard about encouraging strong international banks to sink roots in our domestic economies in a way that strengthens their contribution to financial stability. Otherwise, financial openness carries high risks.

The Role of Finance in Asia's Economic Rebalancing

- Next, I want to talk about the role of finance in the rebalancing and restructuring efforts of Asia.

- Here, it is useful to distinguish between financial development and financial deepening on one hand and financial globalisation on the other.

- Financial globalisation can contribute significantly to domestic financial development, but it is neither a sufficient nor necessary condition.

- ***Domestic financial liberalisation and financial deepening can achieve most of the benefits of financial globalisation while minimising the risks of contagion from abroad*.**

    - Empirical research has not found a clear link between financial globalisation and economic growth in EMEs,[3] but several studies have shown stronger and more convincing evidence of a causal relationship between domestic financial development and economic growth.[4]

- ***From Asia's perspective, liberalising and deepening the financial markets is an important element in economic rebalancing and restructuring.***

- The new global economic landscape over next decade will be shaped by three fundamental forces:

    - Deleveraging in AEs – this will mean slower economic growth in AEs.

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[3] See for example Kose, A, Prasad, E, Rogoff, K and Wei, S-J (2009), "Financial Globalisation and Economic Policies," *Global Economy and Development*, Working Paper No. 34, Brookings Institution. That no significant link was found does not of course mean that no such link exists, as the empirical studies are subject to the problem of the bundling of financial opening with a potential host of other growth-friendly reforms, and the endogeneity of the globalisation decision itself.

[4] See the survey in Levine, R (2005), "Finance and Growth: Theory and Evidence," in P Aghion and S N Durlauf (eds.), *Handbook of Economic Growth*, Amsterdam: Elsevier, pp. 866–923.

- Re-regulation globally – this could mean less financial intermediation globally.

- Demographic change globally: population ageing in AEs and rise of affluent middle class in Asia will mean shift in consumption demand from AEs to EMEs in general, and Asia in particular.

- What is the upshot? Net exports will no longer contribute as significantly to Asia's growth in the next decade as it has in the past.

- To counter a potentially significant decline in overall growth, Asia needs to boost domestic and regional sources of growth.

  - This calls for policies to encourage greater consumption spending in some countries and more investment spending in others.

  - In particular, Asia continues to lag in infrastructure capacity and needs to invest significantly more in the years ahead.

  - Successful rebalancing involves a multi-faceted economic restructuring process that entails macro and micro adjustments:

    - Fiscal reforms are crucial. A more developed social safety net can reduce the need for high individual savings.

    - Appropriate macroeconomic policies are also important. Real exchange rate appreciation will facilitate expenditure switching towards the non-tradable (domestic) sector.

- If appropriately carried out, financial sector reforms can complement and accelerate the process of economic restructuring in Asia by improving the intermediation of savings and raising the efficiency of investment spending.

- The deepening of capital markets, in particular, is of critical importance.

- The ongoing consolidation by European banks and changes in regulatory and prudential requirements mean that there is an increased need to develop alternative sources of long-term financing to traditional bank loans.

- Households will also benefit from financial liberalisation because their savings can be put to better use, thus generating higher returns.

    - By fostering financial innovation, liberalisation provides savers with a broader menu of investment and insurance products, thus lessening the motive for precautionary saving.

    - Jain-Chandra and Chamon argue that improved household access to financial services provides a net boost to consumption. For China, further financial reforms would raise private consumption by about 5% of GDP.

    - Williamson and Mahar document that the Mexico and Thailand experienced increasing trends in consumption after liberalising their domestic financial sectors in the 1980s and 1990s.[5]

<u>When Financial Globalisation</u>

- ***Financial globalisation is eventually necessary to maximise the benefits of domestic financial reform but it should not be rushed and should be carefully sequenced.***

- In the longer run, greater financial integration and globalisation can potentially yield additional benefits for Asia.

- However, certain pre-requisites or 'threshold' factors have to be met before a country can be expected to benefit from financial globalization. Otherwise, the country could experience more crises and lower growth.

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5 Williamson, J and Molly, M (1998), "A Survey of Financial Liberalization", *Princeton Essays in International Finance*, N0. 211.

- Empirical work suggests that only countries with reasonably good public institutions, adequate control of corruption, and a minimum level of human capital seem to be able to translate greater financial openness into higher investment and growth on a sustained basis (Prasad et al., 2003; Kose et al., 2006).[6]

- Some empirical papers have reported that greater benefits from financial globalisation were reaped when domestic financial markets are more developed and well-supervised. Indeed, domestic financial deepening, along with merchandise trade expansion, makes capital controls more difficult to enforce.[7]

- One of the lessons learnt in the Asian financial crisis is that domestic financial reforms should precede financial globalisation.

  - One suggestion is to first remove controls on long-term capital flows and trade-related flows to facilitate economic growth and development.[8]

  - Next, controls on short-term flows can be removed after interest rates have been liberalised and government finances put on a sound footing.

  - Finally, when domestic banks are sufficiently strong and a sound system of banking regulation and supervision is in place, free entry and exit of foreign banks can be allowed.

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[6] Kose, M, Prasad, E, Rogoff, K and Wei, S-J (2006), "Financial Globalization: A Reappraisal and Synthesis," *Journal of Economic Literature*; Prasad, E, Rogoff, K, Wei, S-J and Kose, M (2003), "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence," IMF Occasional Paper No. 220.

[7] Obstfeld, Maurice (2008), "International Finance and Growth in Developing Countries: What Have We Learned?" Commission on Growth and Development Working Paper Series.

[8] Bernhard, F and Reisen, H (1992), "Towards Capital Account Convertibility," OECD Development Centre Policy Briefs 4, OECD Publishing.

Conclusion

- Let me conclude.

- Stephen Cecchetti started us off yesterday with the succinct observation that finance and financial globalisation are good, but up to a point.

  - I think most of us can agree with that – the challenge is in knowing where that point is.

  - I would suggest that it is not an absolute point – such as a certain credit-to-GDP ratio or capital flows-to-GDP ratio.

  - That point varies across countries and within countries, across time, closely related to their capacity to cope with downside risks.

  - The long-term response to the risks of financial globalisation cannot be insulation but rather building up domestic resilience. But some insulation may be necessary while this resilience is being built up.

- In this regard, Jacob Frankel's analogy of financial globalisation to driving a car is a good one. The choice is not binary: to drive or not to drive. We must drive, we must globalise.

  - But to drive, you need a license.
  - And you must observe speed limits. Driving slower gives you more time to react to shocks and lessens the severity of impact when there is an accident.
  - You must take account of the terrain you are driving on as well as changing weather conditions.
  - And when the engine overheats, you must pull over and stop.

- Thank you.