Some remarks by Jose Dario Uribe, Governor of the Banco de la República, Colombia, at the 11th BIS Annual Conference on "The Future of Financial Globalization."

Panel Discussion: "¿Will Financial Globalization Survive?"
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Today I want to address three issues related to the main theme of the future of financial globalization. First, based on some of the excellent and informative papers presented at this conference, I will offer some thoughts on whether financial globalization should survive and, if so, what conditions make it sustainable. Secondly, based on the Colombian experience, I will discuss some conclusions drawn by Bruno and Shin in their work on the international dimensions of the risk taking channel. And thirdly, I will touch on some consequences that the current process of deleveraging in advanced markets is having on the financial markets of some emerging economies. From the point of view of the latter, these phenomena are important for they affect the sustainability of the financial integration of our economies into the world economy.

1. Should financial globalization survive?

- In the same way that a deep and well-functioning financial system is useful and desirable for an individual country, financial globalization is useful for all the benefits that have been widely recognized in the literature and in policy circles.

- Nonetheless, as in the case of individual financial systems, financial globalization entails risks and challenges derived from three features of financial markets:

    - They are prone to suffer from information imperfections and asymmetries that provide bad incentives and induce excessive risk taking.
    - Failure of some of their institutions or segments may have systemic and macroeconomic consequences.
    - They behave pro-cyclically, propagating and exacerbating macroeconomic shocks.

- As pointed by Taylor, these features give rise to financial crises and to deep and protracted recessions that follow a period of excessive leveraging and risk taking. And, as argued by Lane, financial globalization augments the magnitude and the scope of these problems while making their solution more difficult due to their size, complexity, and the need for coordination between different countries.

- Hence, if some sort or degree of financial globalization is desirable, it must be made sustainable by appropriate “global” supervision and macro and microeconomic regulation in the same fashion that a healthy financial system is sustained in an

individual country. This would probably be part of the "first best" solution. However, it is not a practical one in the current state of affairs. As noted by Taylor, not even Europe, with a commitment to a long term economic and political project, has been able to achieve such an arrangement.

- Therefore, we must move to the world of the "second best" solutions in which a more restricted but sustainable financial globalization is obtained. As the evidence reviewed by Lane suggests, the degree of cross border financial integration between countries depends on the "institutional capacity" of each country. Extrapolating this result to the world as a whole, one may say that the world´s "institutional capacity" to deal with financial integration is rather limited.

- This not only applies to the insufficient ability to coordinate adequate crisis resolution, liquidity or capital regulation, supervision, and provision, but it also may be understood in a wider sense as the absence of general macroeconomic policy frameworks that would minimize the probability of financial imbalances and financial crises. As noted by Taylor, unlike emerging economies in the past decade, advanced economies generally did not conduct countercyclical fiscal policies or build buffers in good times. Will they in the near future? Unlike some emerging economies which were badly hit by previous financial crises, advanced economies did not pay enough attention to credit growth in their monetary/financial policy strategies. Will they from now on?

- Thus, as long as neither of these two–liquidity provision and crisis prevention/resolution mechanisms—are sufficiently coordinated between countries, nor appropriate fiscal/monetary policy frameworks are in place in relevant advanced and emerging economies, it could be better to proceed on a gradual path of financial globalization with the following features inter alia:

  - Limited bank and private sector leverage: This would cut credit supply and increase the cost of finance but would reduce the size and contagion of financial market disruptions.
  - Stricter FX and local currency liquidity requirements: This is key, especially in the absence of coordinated liquidity provision plans between countries.
  - International banks should preferably work as fully incorporated local institutions wherever they are present, subject to the domestic capital and liquidity regulations, and covered by the domestic financial safety net: Again, this could make credit more expensive, but it would limit contagion and rely on supervision and regulation by agencies that are probably more familiar with the local risks and environment.
  - Financial innovation should not be greatly discouraged, but new products should carry large capital requirements whenever their risks or valuation are not fully understood by the authorities.
  - There should be large countercyclical capital and provisioning requirements (with respect to the credit cycle) embedded as part of the existing rules: This way, an excessive credit expansion is not only more easily curbed, but it is

also made less likely since banks can anticipate an increasing cost of feeding it.

- Elements along these lines are included in the Basel III initiative and are welcome. It will be desirable for them to be shared by many financially relevant economies, so that regulatory arbitrage is limited and the effectiveness of the regulation is not significantly weakened. This would be a minimum of international coordination necessary for financial globalization to be sustainable. Some may argue that this is a return to financial repression. That is one way to put it. Another is that financial globalization went too far in the first place given the "institutional capacity" of the world as a whole, so it is necessary to step back somewhat.

- Yet, although a movement in this direction is clearly a retrenchment of financial liberalization for a number of advanced countries, for many emerging economies there is still ample room to continue adopting financial products and deepening their financial systems within this more prudent framework.

- Finally, a word on financial globalization and macroeconomic resilience in some emerging economies. The behavior of some emerging countries in the face of the shocks observed since 2008 illustrate the benefits of flexible exchange rate regimes (among other policy response elements). The shock absorber role played by the exchange rate and the fact that flexible regimes enabled countercyclical monetary policy responses suggest that for many emerging economies, this will continue to be a useful part of their policy framework. But a properly working flexible exchange rate regime requires limits on currency and FX maturity mismatches, limited financial dollarization and other related regulation. Hence, from the point of view of these economies, sustainable financial and trade globalization imply the presence of such restrictions on some financial activities and exposures

2. On the international dimensions of the risk taking channel.

- In a very interesting paper, Bruno and Shin explore the international dimensions of the risk taking channel. To be more specific, they studied the influence that monetary policy responses in advanced economies may have on credit supply and risk taking in emerging economies.

- A long period of low interest rates in advanced economies induces cross border lending by international banks and this reduces the cost of funds for emerging countries' banks and their respective customers (firms and households). At the same time, it appreciates the emerging country's currency. The latter effect increases the net worth of the emerging country residents, thereby reducing their perceived risk and opening additional room for more cross border lending. Moreover, the new capital flows stabilize the exchange rate and further enhance the scope for cross-border lending. The trouble is that these cycles feed excessive risk taking in the

emerging economy and exacerbate both credit and expenditure buildup. This makes the reversal of the external conditions traumatic.

- This is a relevant channel of transmission and poses a serious challenge to monetary policy makers in emerging economies. The case of Colombia may be of interest for evaluating policy responses to this phenomenon. Our position is rather fortunate because we have a substantial non-tradable sector and we are net commodity exporters. This means first, that the pass-through from the exchange rate to domestic prices is low, and second, that large capital inflows tend to coincide with external conditions that enhance national income and aggregate demand. Hence, policy interest rates have been generally raised during periods of large capital inflows, thus reducing the impact of the risk taking channel.

- In addition, the policy framework itself has features that dampen the effects of this channel. To begin with, the flexible exchange rate regime and an increasingly credible inflation target have weakened the pass-through further. The downward pressure on policy rates stemming from the appreciation of the currency has thereby been reduced. Second, exchange rate flexibility also discourages the emergence of currency mismatches (due to the larger volatility of the exchange rate) and decreases the incentives of local borrowers to use cross border, dollar-denominated funds. Third, we have strict regulation preventing financial dollarization and limiting currency and FX maturity mismatches by banks. In practice, this means that all cross border financing must be lent internally in the same currency and with shorter or equal periods as the original foreign funds.

- Thus, the scope for a substantial expansion of local credit following a reduction in external interest rates is rather limited. Intermediated cross border flows are low relative to the total credit supply. However, in some instances it is possible that the collateral valuation effects could be too strong, or currency mismatches in the real sector might rise significantly, or overall real sector leverage increase too fast, or the appreciation pressures could become strong enough to keep policy rates too low for too long. In these cases, we are willing to use and have used temporary capital controls in the form of unremunerated reserve requirements on external loans. These are also sometimes coupled with the imposition of temporary marginal reserve requirements on domestic deposits.

- Is this policy response to the risk taking channel easily applied in other emerging countries? Probably not, especially in more open economies, where the pass-through is larger and the possibility of raising policy interest rates in the face of declining external interest rates is more restricted. In these cases, conflicts between price and financial stability may be more common and could require more frequent deviations from the inflation target (with the corresponding communication effort) or more frequent use of capital controls.

3. **On some implications of advanced economy deleveraging for emerging countries.**

- As part of their deleveraging process, financial institutions in advanced economies are selling a number of assets and businesses they hold in emerging countries. The buyers in many cases have been financial institutions from emerging economies.

- This poses a risk and a challenge for financial regulators and supervisors in the emerging world. For example, Colombian conglomerates are now in control of several banking and pension businesses across Latin America. Our regulation and monitoring plans were designed to deal with an arrangement in which foreigners owned part of the local financial system, not the other way around.

- Critical questions emerge. Do we have adequate and timely information on the credit, liquidity, and market risks of the Colombian banks abroad? Do we understand the regulatory frameworks and financial safety nets in the host countries? Can we assess the consolidated currency mismatches of the Colombian conglomerates, including the exposures of their branches abroad? There are many others.

- This is an issue that must be closely monitored since the ownership of many financial institutions across the emerging world may now be in the hands of agents whose home regulatory and supervisory agencies may not have sufficient expertise or resources to deal with systemic problems at the regional level (as opposed to the national level).

- Of course, this is relevant to both the host and home countries. For the host countries, it is key to gauge the risk control, liquidity/capital provision facilities, and resolution mechanisms of important parts of their financial systems. For home countries, it is crucial to assess the vulnerability of their financial system and the fiscal, exchange rate, and monetary implications of this new exposure. For both, it is a contagion channel that must be understood and monitored.

- In short, some dangers of financial globalization discussed in this Conference may now be transferred from advanced economies to other parts of the world whose "institutional capacity" may be even lower than that of the developed world.

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