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Foreword

On 19–20 June 2006, the BIS held its fifth Annual Conference, on "Financial Globalisation", in Brunnen, Switzerland. The event brought together some 60 senior representatives of central banks, academic institutions and the private sector to exchange views on this topic. This BIS Paper contains the opening address by William White (Economic Adviser, BIS), the keynote speech by Stanley Fischer (Governor, Bank of Israel), the contributions to the panel on “Review of recent trends and issues in financial sector globalisation”, and the prepared remarks of the participants at the Policy Panel. The Policy Panel discussion was chaired by Malcolm D Knight (General Manager, BIS); the panellists were Vittorio Corbo (Banco Central de Chile), Raguram Rajan (IMF), Usha Torat (Reserve Bank of India) and Zdeněk Tůma (Czech National Bank).

Conference programme

Monday, 19 June

09:00	Opening remarks:	William White (BIS)
09:15	Morning Chair:	Kazumasa Iwata (Bank of Japan)

Session 1: Democracy and globalisation

Authors:	Barry Eichengreen (University of California, Berkeley) and David Leblang (University of Colorado, Boulder)
Discussants:	Marc Flandreau (Institut d'Etudes Politiques de Paris) and Harold James (Princeton University)

11:15 **Session 2: Globalisation and asset prices**

Authors:	Geert Bekaert (Columbia University)
Discussants:	Alan Bollard (Reserve Bank of New Zealand) and Sushil Wadhwani (Wadhwani Asset Management)

14:15	Afternoon Chair:	Lorenzo Bini Smaghi (ECB)

Session 3: Sudden stop and recovery: lessons and policies

Author:	Guillermo Calvo (Inter-American Development Bank)
Discussants:	Randall Kroszner (Board of Governors of the Federal Reserve System) and Takatoshi Ito (University of Tokyo)

16:15 **Session 4: Panel on "Review of recent trends and issues in financial sector globalisation"**

Lead-off presenter:	Christine Cumming (Federal Reserve Bank of New York)
Other Panellists:	Jose Luis de Mora (Banco Santander Central Hispano), David Llewellyn (Loughborough University) and Guillermo Ortiz (Banco de México)

19:00 Dinner

Keynote address:	Stanley Fischer (Bank of Israel)

Tuesday, 20 June

09:00	Morning Chair:	Donald Kohn (Board of Governors of the Federal Reserve System)

Tuesday, 20 June (cont)

Session 5: Financial globalisation, governance and the evolution of home bias

	Authors:	René Stulz (Ohio State University), Bong-Chan Kho (Seoul National University) and Francis E Warnock (University of Virginia)
	Discussants:	Philip Lane (Institute for International Integration Studies) and José Viñals (Banco de España)
11:00	**Session 6: Global "imbalances"**	
	Authors:	Ricardo Caballero (Massachusetts Institute of Technology), Emmanuel Farhi (Massachusetts Institute of Technology) and Pierre-Olivier Gourinchas (University of California, Berkeley)
	Discussants:	Jeffrey Frankel (Harvard University) and Michael Mussa (Institute for International Economics)
14:00	Afternoon Chair:	Malcolm Knight (BIS)
	Session 7: Policy panel	
	Panellists:	Vittorio Corbo (Banco Central de Chile), Raghuram Rajan (IMF), Usha Thorat (Reserve Bank of India) and Zdeněk Tůma (Czech National Bank)

Participants in the meeting

Ahmed Al Kholifey Assistant Director General Research and Statistics Department	Saudi Arabian Monetary Agency
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Kazumasa Iwata Deputy Governor	Bank of Japan
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Philip Turner	Head of Secretariat Group
Dietrich Domanski	Head of Macroeconomic Monitoring
Stefan Gerlach	Head of Secretariat, CGFS
Ramon Moreno	Head of Emerging Market Issues
Frank Packer	Head of Financial Markets

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Opening remarks

W R White

May I begin by welcoming you all to Brunnen. As happened two years ago, the fact that the Basel Art Fair coincided with our planned conference meant that there was effectively no hotel accommodation to be found in the city. Accordingly, we all find ourselves in this beautiful place, albeit somewhat harder to reach than Basel. May I also say, representing the central bankers assembled here, that I am particularly pleased to welcome our many friends from universities and think-tanks around the world. As on previous occasions, we central bankers will gain a great deal from your analysis of the problems that we face. And by the same token I hope that, after this conference, you will have a clearer idea of what central bankers think the problems are. Putting the two together, I also hope that you might be inspired to think about these problems still further after the conference ends.

Policymaking has always been a difficult business, but recent structural changes in the global economy have made things more difficult still. In light of these changes, the pessimists would contend that the fundamental analytical framework we use needs to be seriously reconsidered; in particular, we might ask whether the postwar Keynesian consensus needs to be confronted again with prewar business cycle theory. Others are more optimistic about the continuing relevance of their model, but even they are still troubled by significant parameter shifts and large forecasting errors. Everywhere one senses a growing modesty in our assessment of what we really know. The underlying issue is what Hayek in his 1974 Nobel Lecture called “The pretence of knowledge”, and what Larry Summers has referred to more recently as “The scientific illusion in empirical macroeconomics”.

The structural changes I refer to are three in nature; one real, one monetary and one financial, the last being the topic of this conference. The first change has profoundly affected the real global economy. Liberalisation of product and factor markets, allied with technological developments, has increased output in many countries and particularly so in the previously centrally planned economies. I believe that these developments have aided central bankers everywhere in their attempts to reduce inflation and to keep it low. The second major change has in fact been the growing global commitment to this objective after the great inflation of the 1970s. The third major structural change, again reflecting both deregulation and technology, has been the growing completeness and integration of world financial markets. While the efficiency gains associated with such developments are not in question, it could also be contended that they pose a particular challenge to central bankers, and not only during the transition period to a more liberalised regime.

I will not spend much time “proving” that financial markets today have become highly globalised in character, and thus more complete. While the size of international capital flows (relative to output) was likely higher prior to World War I, the short-term nature of many of today’s flows, the high turnover in financial markets, the multiplicity of agents, the number and complexity of instruments, and the speed with which market participants can react to new information is surely unprecedented. Moreover, the global reach of financial institutions, particularly banks, also needs to be noted. In large parts of Latin America, central and eastern Europe and Africa, foreign banks constitute the largest part of the banking system. Moreover, they both borrow and lend in local currency and are being increasingly integrated into the local economy.

These cross-border developments have had a number of implications. Let me briefly consider a few of these, before turning to how they can significantly complicate the lives of policymakers.

Perhaps the first implication to note has been the growing integration of financial markets, including those in emerging market countries, with subsequent impact on the covariance (perhaps even "excessive covariance") of asset prices. Over the last year or two, equity prices in virtually every emerging market economy (EME) have risen strongly while sovereign spreads have dipped to record lows. Even more astonishing, the sharp increase in house prices in most industrial countries has also been reflected by similar sharp increases in many EMEs. While arguments can be put forward to explain these developments in terms of "pull" factors (better policies) in EMEs, there seems a reasonable chance that "push" factors are also in play. The sharp increase in competition in the financial services industry in the industrial world, together with high hurdle rates and very low policy rates, has fostered a search for yield that has affected markets everywhere.

A second implication is that current account deficits have become easier to finance than before. We saw this in Mexico in the early 1990s, in East Asia a few years later, and in central and eastern Europe more recently. The ease with which the United States has managed to attract funds to support its current account deficit, and large capital investments abroad, is also remarkable. This said, the growing proportion of inflows in the form of shorter-term and inherently safer instruments (Treasuries and agencies) and the growing role of official purchases (especially by Asian central banks) may both indicate that the private sector appetite for dollar-denominated assets is finally beginning to wane.

A final implication has to do with currency mismatch effects. We are all aware of the devastating effects that currency mismatches had in the Mexican crisis of 1994, the Asian crisis of 1997, and the Argentine crisis of 2001. In those cases, borrowers had borrowed in foreign currency and devaluation punished the debtors. Today, we have a similar phenomenon in that the United States has borrowed heavily abroad, but almost entirely using dollar- denominated liabilities. This implies that, just at the time that creditor countries could be facing the challenge of appreciating currencies and more competitive trade markets, they would also be facing the "headwinds" of sharp wealth losses on dollar-denominated assets. This will hinder, not help, the process of global current account adjustment.

In what way does the international dimension complicate the lives of central bankers? Consider first the conduct of monetary policy in tightening mode, with price stability as the ultimate objective of policy. As interest rates begin to rise, the currency will tend to strengthen. This will have a downward influence on inflation, implying that interest rates have to rise less than otherwise. This can have two dangerous effects. First, if the combined effect on the price of tradables is greater than on non-tradables, the trade account may deteriorate. Second, with domestic interest rates relatively low, asset prices could rise and even take on "bubble"-like dimensions. With spending further supported by this phenomenon, there would likely be further deleterious effects on the trade account. In the end, the markets could lose patience and a crisis might follow.

This sounds very much like the dynamics of the Mexican and Southeast Asian crises, and the more recent experiences of Iceland, Hungary, New Zealand and a number of others. Indeed, the external and internal imbalances faced by the New Zealand authorities, the pioneers of inflation targeting, have recently led them to undertake a complete review of their current monetary framework. And while it would be tempting to say that the international complication is really only material for small open economies, what has been going on in the English-speaking countries, in particular the United States, also seems qualitatively similar. The rate at which the United States is becoming externally indebted is, in itself, a cause for concern. Moreover, such concerns must be heightened by the recognition that the money lent by foreigners has been spent on bigger houses and higher oil prices, rather than investment in the tradable goods sector. The US deficit also has the potential to unleash a bout of global protectionism, which is not the case when small economies run into similar problems.

Easing monetary policy in a financially integrated world also has complications. One possibility is that the exchange rate will again do the lion's share of the work. The danger here is that an orderly decline will turn into a disorderly one, necessitating a sharp increase in policy rates to stabilise the situation. We saw this on a number of occasions in Canada in the 1980s, and we have had a more recent example in Turkey. The end result of such policies could be tightening, rather than the intended easing. It is not a pleasant experience to find yourself going in the opposite direction from that originally intended.

In contrast, the exchange rate might not move enough to stimulate the economy, via the trade side, perhaps because the countries that would have an appreciating exchange rate in consequence refuse to allow it to happen. This was the situation which presented itself to the United States between 2001 and 2004, as China and (to a lesser degree) other Asian countries refused to allow their currencies to appreciate. The upshot of this situation was that the United States had to rely disproportionately on lower policy rates to do the stimulative work, while China and other countries turned to easier (or at least not tighter) monetary policy to resist currency appreciation. The result was a world awash in liquidity, saved from inflation only by the massive increase in global supply potential arising from the re-entry into the global economy of countries like India and China.

But the globalisation of the financial system poses other policy complications as well. For those of us who work at the BIS, questions having to do with financial stability are only slightly less important than those having to do with monetary or price stability. Banking supervision in a globalised world poses huge challenges for the relationship between home and host supervisors as they collectively seek to prevent crises from happening. The oversight of international payment and settlement systems is another important cross-border issue. And in a financial crisis where emergency liquidity assistance is required, who is to give it? Home? Host? And in what currency, given the multilateral commitments of the financial firm likely to be in trouble? There are a lot of issues to think about here, particularly since the absence of clarity about the limited role of the public sector positively encourages moral hazard. It is already possible that many firms already consider themselves either too big or too complex to fail.

Should the global financial system be subject to a sharp shock somewhere, the issue of how large, complex financial institutions might be wound down remains unresolved. There are continuing concerns about the limitations of information sharing among the various countries affected. Moreover, the question of who might bear the costs still remains undecided. At the worst, this leaves open the possibility of the failure of a global bank that is "too big to save". At the best, this opens the possibility of "gaming" in the midst of a global problem as officials try to act in their own national interest. And, in addition, there is the problem of relatively small economies whose banking and financial systems are dominated by financial firms from other countries. How are they to continue operating efficiently when such dominant firms fail?

To finish my comments, this is all by way of a typically rather dark BIS welcome to those who have joined us here in Brunnen. The globalisation of financial markets provides both enormous opportunities and enormous challenges. I hope that in the course of the next day and a half, we will show some evidence of having responded to the challenges in particular. In anticipation of this outcome, let me thank all of you who have come long distances to be here, especially our academic friends. And finally, let me thank my economist colleagues at the BIS, Claudio Borio, Gabriele Galati and Andy Filardo, and also Janet Plancherel for all the logistics. Everyone has put in great efforts to make this event happen. My thanks to all.

Financial market liberalisation

Stanley Fischer[1]

In this lecture I will discuss financial globalisation, the opening of the capital account, and the increasing global integration of financial markets. I will first sketch the background for our discussion, then discuss the process of integration into global capital markets, especially from the viewpoint of emerging market and developing countries, and finally comment on two possible risks in the current international financial system.

I. Background

We are living in the second great era of financial globalisation. The first era of globalisation ended in 1914. By every measure of financial sector globalisation,[2] international capital markets were more open in 1914 than they were at any time up to the 1970s.

That first great era of financial globalisation started with the invention of the telegraph. If you look at when rates of return in different financial markets began to move together, it was when the telegraph was invented. Thereafter, within minutes, interest rates and prices in different financial centres were essentially tightly linked. Now, in the twenty-first century, we have cut the minutes down to microseconds, but the critical change took place 150 years ago.

We are living, in this second age of financial globalisation, in a world of far greater financial sophistication than ever before. I mean by that particularly the explosion of financial instruments based on derivatives - on the Black-Scholes derivatives pricing formula and developments from it, and on the insights of Modigliani and Miller as to how to think about the value of a firm. And of course we are also living in an age of far wider access to information, far greater flows of information and more rapid communications and transportation. This acceleration and widening potentially adds to the efficiency of the system, but also leads many to fear that the system is more vulnerable to accidents than it ever was before.

Among the industrialised countries, financial sector liberalisation is seen as a desirable goal, although the legacy of controls from the 1930s and from World War II took a very long time to disappear. As you know, in France it took until the late 1980s to finally get rid of capital controls, and even in the United Kingdom capital controls were finally abandoned only in the early 1980s.

Why did it take so long? In part because of the inertia that comes from having lived for a long time in a particular environment, with controls, and thinking that any change in the system would be destabilising. The Organisation for Economic Co-operation and Development

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1 Governor, Bank of Israel. I was scheduled to make a dinner speech at the Brunnen Conference, but unfortunately had to deal with an urgent business issue that prevented my participation. I had planned to base my talk on material included in this paper, which is a revised version of a presentation delivered at the OECD conference on “Balancing Globalisation”, held in May 2006. I am grateful to the OECD for granting permission to reprint it.

2 See Maurice Obstfeld and Alan Taylor , *Capital Markets: Integration, Crisis, and Growth.* Cambridge: Cambridge University Press, 2004.

(OECD) played a major role in promoting capital account liberalisation among the industrialised countries, and it was understood within the European common market and later the EU that capital mobility was essential to economic integration. It is interesting that this point was grasped early, partly under German influence, among a group of countries that were in other respects quite dirigiste. It was good from the viewpoint of the development of capital markets and indeed of the industrialised countries that this view prevailed.

There has been a more questioning attitude towards capital account liberalisation among emerging market and developing countries. These countries too had emerged from World War II with extensive controls. In addition, most economists were not used to analysing financial markets. The fundamental economic case for free capital movements is the same as the case for free trade, and you can even use the same diagrams to show that. But there are leading trade theorists who think capital mobility is different, and that there is something about trade in financial instruments that is different than trade in goods. This may be due to the failure to recognise that while regulation is almost certainly more necessary in financial markets than in goods markets, the need is not for regulation of international capital flows, it is for regulation of financial markets, domestic and/or foreign - and that distinction may not have been drawn sufficiently.

II. The capital account crises of the 1990s

Despite the underlying concerns about the potential dangers of international capital flows, a growing momentum towards capital flow liberalisation developed during the mid-1990s. Shortly before the Asian crisis, the G-7, following an initiative by the British, introduced a proposal to amend the International Monetary Fund (IMF) Articles of Agreement to make the promotion of capital account liberalisation one of the goals of the IMF. As you know, the charter of the IMF makes the promotion of free trade in goods and services a goal of the Fund. But with regard to capital movements, the Articles of Agreement state that the Fund may require a country to impose capital controls (to prevent or mitigate a balance of payments crisis), but do not suggest that the Fund should support liberalisation of the capital account.

As the capital account amendment initiative gathered strength, Managing Director Camdessus and I emphasised that what we were supporting was not immediate liberalisation of the capital account, but rather *orderly* capital account liberalisation. However, while we were busy emphasising orderly capital account liberalisation, the Asian crisis intervened, and the crisis countries, and others, blamed the crises on aberrant and excessively powerful capital flows, and particularly on hedge funds.

Soon there was no capital account amendment of the IMF Articles of Agreement, and the proposal in the OECD for an agreement on foreign direct investment, that is, a code on foreign direct investment, fell by the wayside around the same time, driven by similar fears.

With an extra 10 years' perspective, how should we evaluate the capital account crises of the 1990s? First, and critically, almost every crisis of the 1990s involved a de facto or de jure pegged exchange rate: that applies to every emerging market crisis of the period except that of Brazil in 2002. Fixing the exchange rate or protecting an exchange rate provides an invitation to the private sector to bet against the authorities if the capital account is open: in short, the impossible trinity.

I believe that the move to flexible exchange rates has made more of a difference to the international financial system than any other change. That change takes away a major risk factor. By flexible exchange rates I do not mean *only* freely floating rates, exchange rate systems in which the central bank does not intervene; what I mean is a system in which, if the pressure rises, the country can allow the exchange rate to adjust without changing the entire basis of economic policy. So managed floating comes within this definition of a flexible exchange rate, provided that the currency is indeed allowed to be flexible.

The move to flexible rates does not altogether rule out foreign exchange crises. There has just been a foreign exchange crisis in Iceland, which, despite Iceland being a very small economy, produced ripples in many other countries. Although Iceland has a floating exchange rate, the markets believed that the current account deficit was excessive, and when that became the predominant view, the exchange rate moved very rapidly. Similarly, the Brazilian crisis in 2002 took place in a floating exchange rate system; it was caused by the fear that Brazil might not service its debt if Lula were elected president.

However, it is noteworthy that the economy in both these crises did not collapse in the sense that economies collapsed in the crises of the1990s. In each case, the economy suffered a major and unpleasant shock, but the system did not suffer the stresses that the crisis economies of the 1990s and early 2000s did.

Beyond pegged exchange rates, inappropriate macro policies were a significant factor in almost every one of the crises. So was the lack of transparency. The more I reflect, particularly from my current position in the central bank, on the role of transparency, the more I would like to emphasise not only the aspect emphasised in the 1990s - that transparency is important so that the markets know what is happening - but equally the aspect that policymakers cannot do certain things when they have to publish the information.

Consider the Thai example. By the time Thailand devalued in mid-1997, it had essentially run out of reserves and had forward commitments to pay out foreign exchange in very large amounts relative to the scale of the economy. That simply could not have happened if the markets had known the facts.

In addition, in both Korea and Thailand, the liberalisation of the capital account opened the economy to short-term rather than long-term capital inflows first. We will shortly discuss the appropriate sequencing of current account liberalisation.

During the emerging market financial crises many predicted that the affected countries and perhaps others would close their capital accounts. One of the most impressive aspects of the aftermath of the crises is that there was very little change in the openness of the capital accounts. Almost no country withdrew from the international financial system. There were of course changes in Malaysia, which pegged the exchange rate and imposed restrictions on some short-term flows, and restrictions on short-term flows were imposed also in other countries. But no country tried to cut off its capital account interactions to a drastic extent.

That is, countries that went through a very difficult experience, not one that citizens or governments or central bankers would like to suffer through again, reflected on it and concluded that despite the crises, they would be better off staying in the international capital markets. During one of the crises of the 1990s, I asked a finance minister of a crisis country whether he and his colleagues had contemplated imposing capital controls. The answer was that they had, but had concluded against it. He said, “We worked with capital controls in the 1980s, and we are not going to try to do that again; it is a bad system, which does not in the end succeed”.

Now let me return to the question of why capital account liberalisation is desirable. There is a very simple text-book story about the intertemporal allocation of resources, which says that some countries want to save more, some countries have better investment opportunities, and capital needs to flow between them so that those who have a relative desire for saving can save more, and the capital gets allocated to where its rate of return is highest. This is the basic story, although no one expected that the intertemporal allocation would end up with most of the capital inflows going to the richest of the major countries, namely the United States.

A second reason is that financial sector liberalisation is a way of increasing financial sector competition and improving the quality of the financial system by allowing foreign competition.

This is something I see daily: the Israeli economy benefits both by allowing our financial firms to compete internationally and by allowing foreign firms to supply services to Israeli companies. The foreign companies have a better technology or had a better technology. They know how to do things - financial sector engineering - that the locals do not, and if you allow that competition, your companies benefit.

There is a third reason that financial sector liberalisation is a good thing: it changes the outlook of domestic companies, and leads them to think globally. I will expand on this point in a while, drawing on Israeli experience.

III. How to liberalise

A country that wants to integrate into capital markets needs to ensure that its macroeconomic framework is sufficiently strong and that the domestic financial system is sufficiently strong to deal with the possible strains that liberalisation might create. The first element in the macroeconomic framework is the fiscal situation, which needs to be sustainable and preferably robust, not least because it is not desirable that the financial system should be dominated by the financing of government, which has been the situation in the past in many countries.

On the monetary policy side, the exchange rate regime is a key issue. It is theoretically possible to run an open capital account and have a pegged exchange rate, but in that case, the impossible trinity raises its head: a country cannot have an open capital account, a pegged exchange rate and a monetary policy that is dedicated to domestic policy goals. In those cases, the monetary policy can only be dedicated to maintaining the exchange rate peg. So it is theoretically possible to operate an open capital account with a pegged exchange rate, and many countries have done that at times, but I believe that experience suggests that if the capital account is open, it is better to operate with a flexible exchange rate. The domestic and foreign shocks that impact on an economy are easier to deal with if the exchange rate can absorb part of the strain, rather than imposing all the adjustment on domestic wages and prices.

If the exchange rate is flexible, then the goals of monetary policy need to be defined. Increasingly, countries are adopting a system of flexible inflation targeting, in which the government defines a target range for inflation and the central bank's job is to hold the rate within that range. But the goal needs to be interpreted flexibly, which is to say that if the economy is hit by shocks, the inflation rate may for a time be permitted to stay outside the target range while the central bank tries to bring it back gradually within the range.

In my new position, I sometimes reflect on what it is that we have got from inflation targeting. The conclusion is that the big achievement is to tie down long-term inflation expectations. The expected 10-year inflation rate in Israel, which has an inflationary history of which we are not proud, is 2.3%, very close to the centre of our band. Once you have stabilised long-term inflation expectations, nominal wages are not going to go crazy, price-setters are not going to go crazy, nominal interest rates are not going to go crazy. And that makes an enormous difference to the overall stability of the system.

Beyond the macroeconomic framework, it is necessary to create a reasonably stable banking and financial system, and that takes a lot of work. And beyond that, a country needs to liberalise gradually, not all at once.

In terms of the type of capital flow, the principles of liberalisation are:

- Liberalise inflows before or simultaneously with outflows;
- Liberalise long-term capital flows before short-term flows;

- Liberalise foreign direct investment before portfolio investment.

In terms of sectors, to liberalise first the business sector, second, individuals, and third, the financial sector.

This is simply a set of principles, but it is not based on deep theory; rather, it is based on what seems to have worked.

Israel went through two liberalisations which are consistent with the lessons stated above. In 1977, after 30 years, the founding Labor Party lost the elections and a new party came to power. The finance minister was a liberal in the European sense - someone who believed in markets, particularly in liberalising the capital account and getting rid of capital controls. At that time the macroeconomic situation was a mess, inflation was high, the financial system was dominated by the banks, and none of the preconditions specified above for a successful liberalisation were in place. Nonetheless the government went ahead and liberalised the capital account soon after coming to power. Within a very short period, the inflation rate had jumped, the economic situation had deteriorated, and soon thereafter the capital account was closed.

That was a liberalisation whose failure taught the lessons that we have learned since then about how not to liberalise the capital account. You should not liberalise with a poor macroeconomic situation, nor with a weak financial system, nor very rapidly.

The second Israeli capital account liberalisation came in the 1990s, following the stabilisation of the economy in 1985. The second liberalisation was very gradual, taking about a decade, and that followed essentially the principles laid out above. By 2003 all capital controls had been removed. This, combined with a move to a flexible exchange rate and an inflation targeting monetary policy, was a very successful liberalisation, one in which there are now no capital controls, nor is there any central bank intervention in the foreign exchange markets. Indeed, there has been no central bank intervention since 1997, but nonetheless we have a very stable exchange rate.

Let me add two points. One is that it is important to liberalise outflows as well as inflows. As a result of the liberalisation of the capital account, rapid growth of the economy, and the very successful high technology sector in Israel, we have large capital inflows - about 9% of GDP last year, about half of that foreign direct investment, the remainder portfolio investment. If we were not permitting outflows, there would be great pressure on the exchange rate, because we are also running a current account surplus.

But Israel also liberalised capital outflows. In 2005 outflows amounted to about 9% of GDP, roughly equal to the inflows. At the start of this process, pension funds, mutual funds, and Israeli household investments were entirely domestic. That is not natural in a small economy; it is not natural even for a big economy not to be diversified internationally. As a result of the liberalisation of outflows, we basically do not have net pressure on the exchange rate from capital flows. Because outflows were liberalised, we do not have to deal with the results of the 'Dutch disease' that would otherwise have followed from the pressure of capital inflows. Our calculation at present is that about 6% of Israeli household assets are held abroad. We believe that process has got considerably further to go, so we expect that the outflows will continue roughly to match the inflows without creating pressures for appreciation.[3]

The second point I would like to make is one that I had not appreciated until recently. I had not appreciated that when you liberalise the capital account, especially in a small economy, you change the philosophy of almost everyone in the economy. Before the liberalisation,

[3] It might be asked whether inflows and outflows have to match precisely if the central bank is not intervening. The answer is no, because short-term flows are not included in the above totals.

people thought locally. By regional standards, we have a reasonably large economy, with a GDP of about 125 billion dollars. By global standards, this is a very small economy, whose GDP is about 1% of EU GDP, and about 1% of US GDP. As soon as the capital accounts opened, business began to think globally - businesses looking for investors began to think globally, their marketing became more actively global, and domestic savers began to think globally. This change transformed the business approach in what, to my mind, is a wholly positive direction.

In brief, as a result of a successful liberalisation, people begin to understand that the world is their stage and not just the local economy.

IV. Current international financial concerns

Let me turn now to address briefly two other issues of current concern: the potential dangers associated with the proliferation of derivative instruments, and global imbalances.

The proliferation and profusion of financial instruments naturally gives rise to concerns about potential risks to the international financial system. The nominal (face) value of derivative instruments amounts to multiples of global GDP. Based on this massive number, it is easy to tell stories about how a financial crisis can occur, as a chain of interlocking derivative contracts unravels due to a failure to settle one contract, which is hedging another contract, which in turn is a hedge to something else. Pretty soon, as in stories in which the payments system grinds to a halt due to a relatively small payments failure, a small event can be made to have frightening consequences. This appears to be consistent with examples from chaos theory in which a butterfly flapping its wings somewhere in Africa can create a typhoon in China.

At the same time, the proliferation of derivative instruments has made it possible to separate risks from their original context, and to shift them to those most willing to bear them. It is for this reason that many regard the development of financial instruments as making the financial system more robust and more efficient. By contrast, Warren Buffett is on record as saying that derivatives are instruments of financial mass destruction. Of course, both those views could be true at different times.

How should we think about the risks? Scenarios involving the unraveling of a chain of derivative transactions are more frightening than realistic, because there are netting arrangements among most institutions which mean that it should generally be possible to offset obligations that have not been settled.

The other concern is that the risks that are passed on through derivative contracts may be inappropriately placed and not adequately recognised. For instance, when banks securitise or hedge a risk, the risk migrates to other places - frequently, it is believed, to insurance companies. The concern is that the risks move from people who understand them to those who do not. There is another possibility, which is that the risks may be moving from places which are forced to mark to market to places which are not forced to mark to market, because many participants in financial markets prefer to retain the capacity to smooth their revenues and profits.

Those risks are out there, and we cannot ignore them, but we should also consider that we have been living in the world of derivative instruments for some time and that we do have experience with them. When the various crises broke out in Asia, we in the IMF would talk to investors and explain the debt situation of the affected country, and the investors would say, “Does that include the value of derivatives?” And we would say “No, those are the debt instruments.” “Ah well, you do not have any understanding of the magnitude of the problem; when they come to settle the derivatives, you will understand that the problem is five times what you think it is.” It did not happen. That is one bit of experience.

Another piece of evidence comes from the one major international financial crisis which was a derivatives crisis: Long-Term Capital Management (LTCM) in 1998. What is interesting about the LTCM crisis is that if Walter Bagehot were writing about it, he would not have to change his basic story very much. Something happened in the financial system - people could not meet obligations - and a central banker got the relevant parties together in a room and told them they had to solve the problem. Somehow they solved it. Three months later it turned out that none of the companies forced into the deal had lost money; in fact, they had made money. And the major risk to the financial system had passed, but not without decisive action by the Fed, and not without damage to some emerging market countries.

In the LTCM crisis there was massive leverage on a scale which turned out to be impossible to deal with in the very short run, and it took time to unwind the effects of the leverage. There are other highly leveraged institutions in the financial system - banks. We do not think very often of how leveraged banks are, but the whole basis of a bank is to use relatively little capital to generate a huge balance sheet. In many nineteenth century banking crises the banks were illiquid and not bankrupt.

So crises like the LTCM crisis have happened in the past, and may well happen in the future even if hedge funds are not involved. They do not necessarily pose a different scale of risk to the system than we have dealt with in the past. They will require the intervention of the lender of last resort, frequently not to lend money but to force a solution that is in the interests of everybody, on people whose individual interests at a particular time seem to diverge from the overall interests of the system.

The second issue causing major concern at present is that of global imbalances. Many believe that the international financial system has permitted imbalances in the US current account that simply would not have been possible before, and that are bound to end badly. Here too it is easy to tell a dismaying story, in which people rush out of the dollar, US stock prices decline, US interest rates rise, the US economy slows or even goes into recession, and the global economy follows.

This is clearly possible. But there are many other possibilities, including a decline in the dollar that may be relatively rapid, but that does not have a massive impact on output because the system adjusts to it. This may sound unlikely, but we have had a similar adjustment that had almost no macroeconomic consequences between 2002 and 2005 when the value of the euro against the dollar changed by around 50%. That appreciation of the euro must have contributed to a slight slow-down in European growth. But there were no financial crises associated with the appreciation of the euro, no major institutions collapsed, and economies adjusted.

Now, of course, if an economy adjusts without a collapse, it adjusts more slowly. It may well be that the US current account will take longer to change than we think. Furthermore, the adjustment need not be from a current account deficit of over 6 percent of GDP to zero; rather, the adjustment could be to a sustainable level of around 2.5 to 3 percent of GDP. Indeed, the US current account has already taken longer to change than we thought it would. The dollar very likely will depreciate, but it is not going to happen steadily; rather, it will take the form of movements around a trend that is hard to discern from day to day and month to month. As my former Citigroup colleague Bob Rubin says, “Markets go up and markets go down”, and that will apply to the dollar too.

If I can put this issue in slightly different words, we are frequently told that we should realise that our situation is like that in the famous story of people falling out of a high building and being asked by somebody as they go by, “How are you doing?” and they say, “Fine so far”! There is another possibility: that we are living in a new world with much deeper financial systems, much more sophisticated financial instruments, much better information flows, one that is more resilient than the world we lived in and that we do not yet understand: that is, the issue may not be how far we have got to fall until the inevitable collapse occurs, but rather that we do not yet understand the ground on which we are standing today.

We cannot know for sure in which of these situations we find ourselves, but the situation may not be as drastic as many believe. In any case, the role of economists is to keep pushing for policy changes that will resolve this situation favourably, and we all know what those policies are. And I am very happy to see that the IMF is now taking a lead in promoting action to implement those policies.

Review of recent trends and issues in financial sector globalisation

Christine M Cumming[1]

Financial sector globalisation, especially foreign direct investment, is substantially altering the financial landscape in emerging market countries. To set the stage for the panel that follows, this contribution provides a brief review of global trends in foreign direct investment in the financial sector (FSFDI) of emerging market countries and an overview of the benefits, risks and policy issues associated with those trends. This overview draws on and updates work sponsored by the Committee on the Global Financial System (CGFS) of the G-10 central banks. The CGFS sponsored a study on policy issues related to the surge of FSFDI into emerging market countries, published in 2004.[2] The CGFS followed with a series of workshops in emerging market countries, summarised in a report in 2005.[3]

Foreign direct investment into emerging market countries surged during the second half of the 1990s, and the financial sector was a major destination of these flows. Economic and financial distress in many emerging market countries during the 1990s created a need to recapitalise banks and other financial institutions in those countries, providing a trigger for FSFDI. Reform efforts, such as financial liberalisation and privatisation, often intensified in the wake of economic distress.

Longer-term economic forces provided momentum for increased FSFDI. As globalisation reduced geographic boundaries in product, services and labour markets, banks and other financial institutions followed their customers overseas, an extension of the historical pattern of FDI. With strong competition and high market penetration limiting growth in the mature financial markets of the G-10 countries, financial institutions there sought opportunities for revenue diversification and operating scale efficiencies in emerging markets. Bringing product innovation and new risk management techniques to emerging market countries called for maintaining managerial control; the need for control favoured FDI over portfolio investments. Advances in technology and communications facilitated the ability to exert that managerial control.

The resumption of strong FSFDI flows since 2003 answered the question of sustainability that remained open in the 2004 CGFS study. The slowdown in FSFDI that occurred in 2002 coincided with global economic weakness and concerns about effective corporate governance, and now appears to have been a pause (Chart 1). In addition to long-term forces promoting FSFDI, further impetus may come from the actual or potential opening of financial sectors in individual emerging market countries through financial liberalisation or bilateral free trade agreements, or, at least prospectively, through global negotiation.

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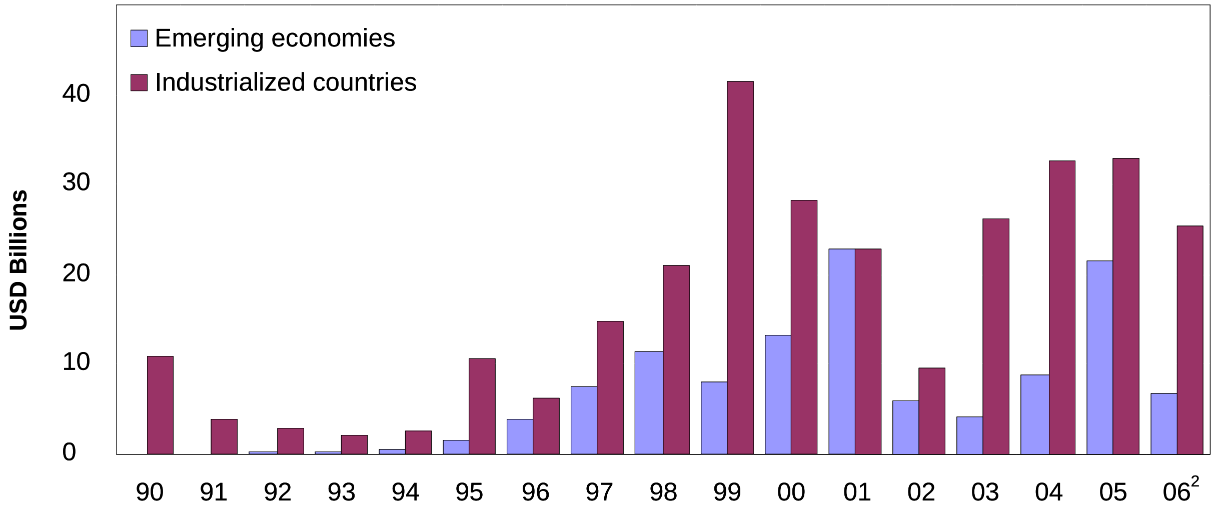
[1] First Vice President, Federal Reserve Bank of New York. I benefited greatly from discussions with and comments from Gerard Dages, Linda Goldberg and Susan McLaughlin and additional comments from Catherine Lomax. The views expressed in this article are those of the author and not those of the Federal Reserve Bank of New York or the Federal Reserve System.

[2] Committee on the Global Financial System, *Foreign direct investment in the financial sector of emerging market economies.* CGFS Publications No. 22. Bank for International Settlements, March 2004.

[3] Ibid, *Foreign direct investment in the financial sector - experiences in Asia, central and eastern Europe and Latin America.* CGFS Publications No. 25. Bank for International Settlements, June 2005.

Chart 1

Cross-border M&A deals in the financial sector[1]



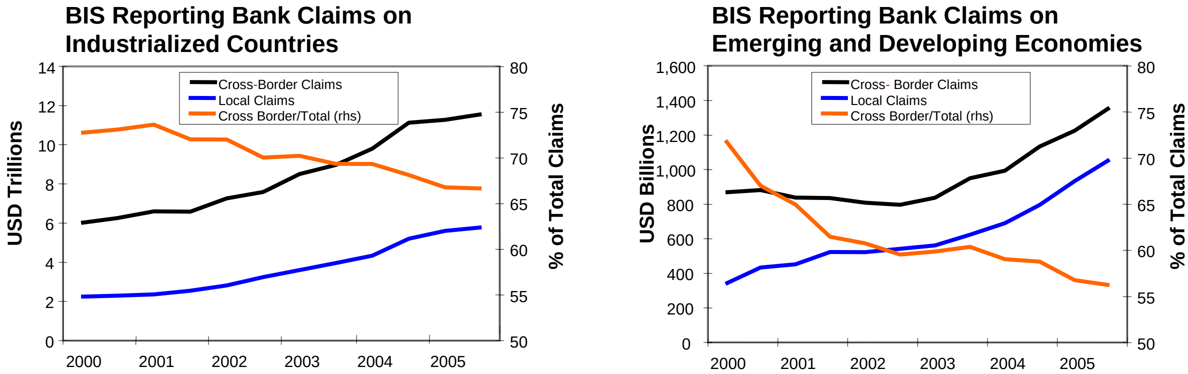
[1] Value of completed M&A deals. [2] Data covers January-5 June 2006.

Source: Thomson Financial.

FSFDI has reshaped the financial landscape in three principal ways. First, the composition of international bank lending has shifted from cross-border lending toward local lending through subsidiaries, even as both components have risen sharply. The share of local claims in total BIS reporting bank claims on emerging economies has risen from roughly 25 percent in 2000 to 45 percent in 2005, and total local claims have reached USD 1 trillion (Chart 2).

Chart 2

BIS reported international bank lending

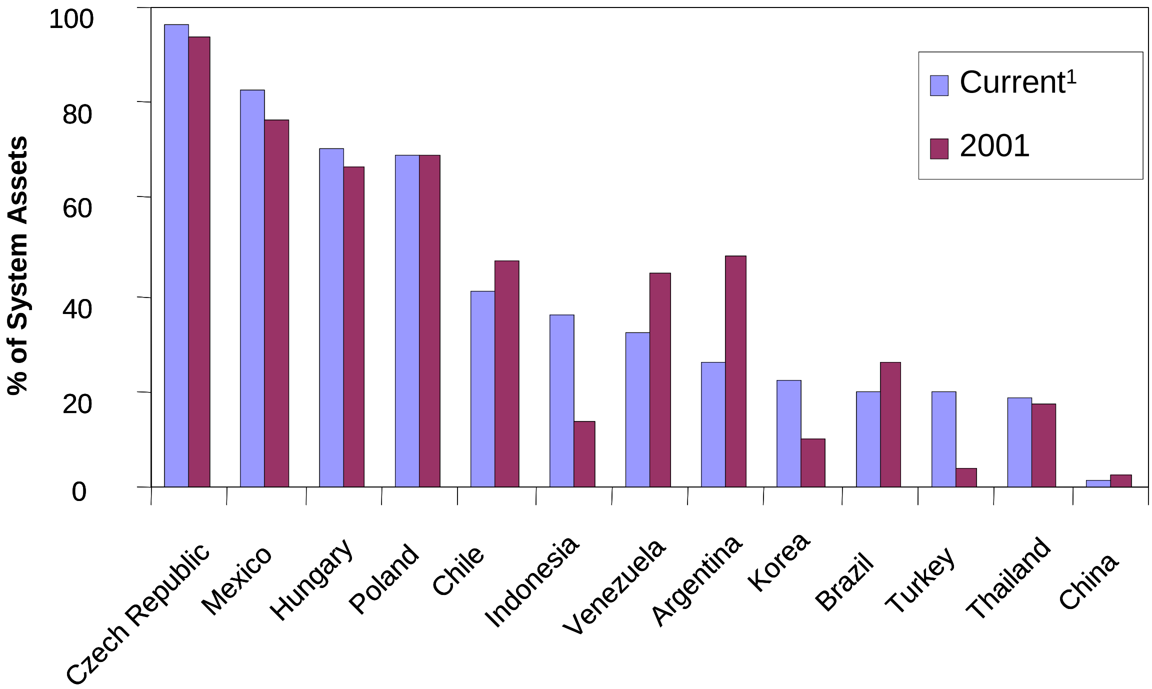


Source: BIS. Source: BIS.

Of greater significance, the share of foreign ownership of emerging market financial systems has risen sharply. The share of foreign ownership of assets in the banking system exceeds 65 percent in the Czech Republic, Mexico, Hungary and Poland (Chart 3). The share has risen substantially in several other countries. Liberalisation efforts, which have continued since the 2004 CGFS report, have led to increased shares of foreign ownership in Indonesia, Korea and Turkey.

Chart 3

Foreign ownership of EM banking system



[1] Current represents the latest data available, generally Q4 2005, but ranging from Q1 2005 to Q1 2006.

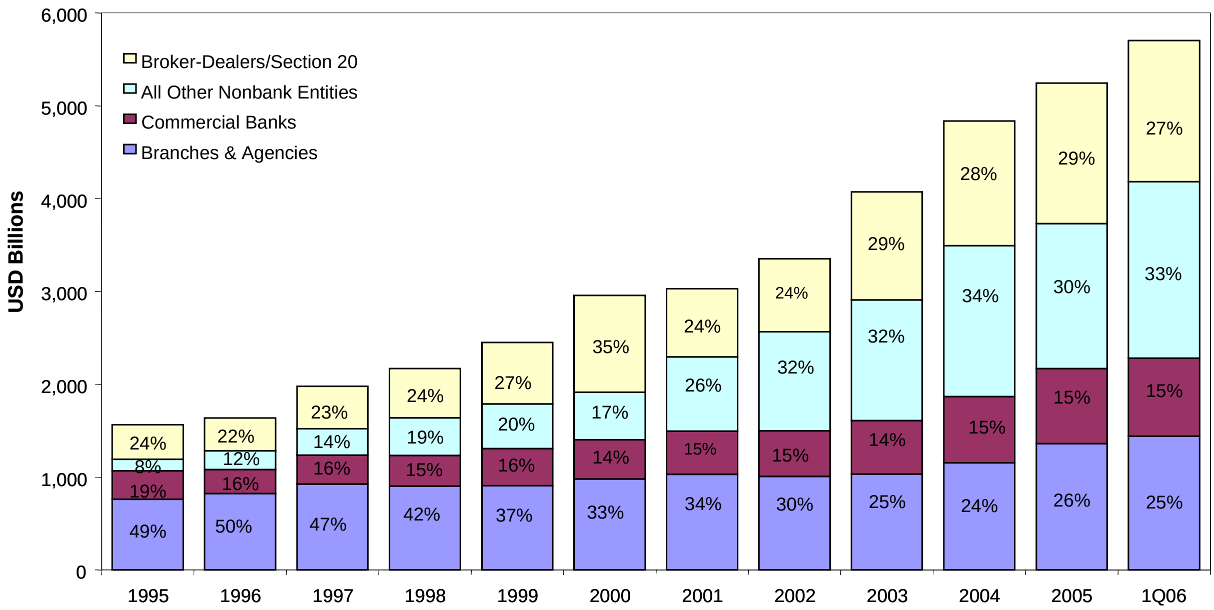
Source: National Central Banks and Bank Superintendents.

While commercial banking is the most important sector, FSFDI increasingly is channelled into other financial activities. The situation in the United States is representative of a global trend that includes the emerging market countries. In 1995, commercial banking accounted for two-thirds of the assets of foreign-owned financial institutions in the United States, most of it in branches and agencies of commercial banks, and securities companies accounted for another 25 percent (Chart 4). In 2005, banking accounted for just over 40 percent of foreign-owned financial institution assets in the United States, securities companies for 30 percent, and other financial institutions, unimportant in 1995, accounted for the remaining 30 percent.

Chart 4

Foreign US BHC assets by type

USD billions and as a percentage of total, 1995-Q1 2006



Source: US Regulatory Reports.

Financial globalisation, especially FSFDI, has created clear efficiency benefits by intensifying competition within the key commercial banking market and increasing financial market completeness. Entry by foreign financial institutions using advanced credit risk assessment and portfolio management tools intensifies price competition and improves credit allocation by better matching price and nonprice terms to the level of credit risk, thereby reducing the role of directed credit. FSFDI has increased the completeness of markets as foreign-owned financial institutions have introduced new financial products to emerging financial markets. The development of securities and derivatives markets provides alternatives to bank loans for channelling credit and liquidity in the local economy. Expanded consumer lending markets improve the economic welfare of households.

FSFDI also has contributed to financial stability in emerging markets by integrating a local financial institution into a larger, global foreign institution. Access to global capital markets through the parent relaxes equity and funding constraints. More subtly, the local institution also becomes part of the global market for corporate control of financial institutions. The development of that market, reflected in active buying and selling of financial institutions, financial business lines, and financial assets and liabilities, provides the opportunity to restructure or reposition a weakly performing financial institution or business unit. The ability to sell businesses or assets to another financial institution presents an alternative to liquidating or winding down underperforming holdings.

While an appreciation of the benefits of FSFDI is widely shared, host country central bankers and financial supervisors have identified several policy concerns, especially when the share of foreign ownership of the financial system is high. The ramifications of integrating major domestic financial institutions into foreign parent organisations are at the heart of these concerns. These concerns are not traditional arguments against globalisation, such as the need for national champions in the financial sector to achieve robust economic growth or the use of the financial system to meet social objectives, although both arguments persist in some G-10 and emerging market countries.

The first concern is the impact of a potential divergence of interests between a foreign acquirer and the host financial authorities. The performance of the domestic financial system, and especially the banking system, is essential to the success of any country's long-term economic strategy. Given the need for infusions of capital and financial management know-how, a high degree of alignment likely existed between the initial interests of a foreign acquirer of a troubled local financial institution and those of the host financial authorities when many purchases were made in the mid- to late 1990s.

Over time, however, the parent institution makes decisions based on global risk and return considerations. While a profit-seeking parent institution has an incentive to develop the host country's banking and financial markets and to accommodate the country's economic growth, in practice, business strategy in and capital commitments to the host country take into account the global set of market opportunities. In some cases, the foreign parent may reduce its local risk tolerance or capital commitment in light of global business considerations.

What may seem to the parent organisation to be marginal decisions in a global business strategy may have major consequences for the availability of credit and liquidity in the host country when the local financial institution is large relative to local markets. While competitive forces, relatively free entry, and a global market for corporate control should replenish any gap in capital or risk tolerance over time, in practice, frictions, entry restrictions and information asymmetries can slow that process. The process could become more disorderly in periods of individual institution or general financial distress.

The second concern is the need for home and host country supervisors to coordinate their supervision of large, multinational institutions. Where foreign-owned institutions make up a large proportion of the financial sector of an emerging market country, the health and well-being of the country's financial system may depend greatly on the financial strength and managerial effectiveness of the parent organisation, as well as the local subsidiary or branch.

Financial supervisors have carried out substantial work on improving the coordination between home and host countries in the Basel Committee on Banking Supervision and the Joint Forum.[4] Supervisory information sharing is seen as key. The consolidated supervisor of the parent organisation needs a fairly complete and direct flow of information from host country supervisors in order to develop a comprehensive picture of the organisation's financial condition and risk profile. In turn, host country supervisors would like to benefit from that comprehensive overview of the parent as they carry out their supervisory responsibilities.

Progress has been made within the G-10 countries in facilitating information flows through memoranda of understanding, planning meetings among supervisors of a global financial organisation, and, in some cases, joint examination of bank activities in host countries by host and home supervisors. Information-sharing activities with emerging market countries need to be widened and deepened where foreign parents are major participants in local markets. In particular, host country authorities want to receive information that is material to the operation of banking and financial markets within that country, recognising that some constraints exist, especially for public parent companies.

Coordination within such a framework, however, increases in difficulty as the number of relevant supervisors increases. The potential exists, but remains to be fully exploited, for

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[4] See, for example, Joint Forum on Financial Conglomerates, *Supervision of Financial Conglomerates,* Bank for International Settlements, February 1998. Chapters D and E discuss a framework and principles of supervisory information sharing. The Basel Committee continues to work toward practical approaches to the need for supervisory information sharing, especially between G-10 and non-G-10 supervisors. Its recent publication, *Home-Host Information Sharing in Effective Implementation of Basel II,* June 2006, reflects an up-to-date review of the issues involved in finding workable frameworks for information sharing.

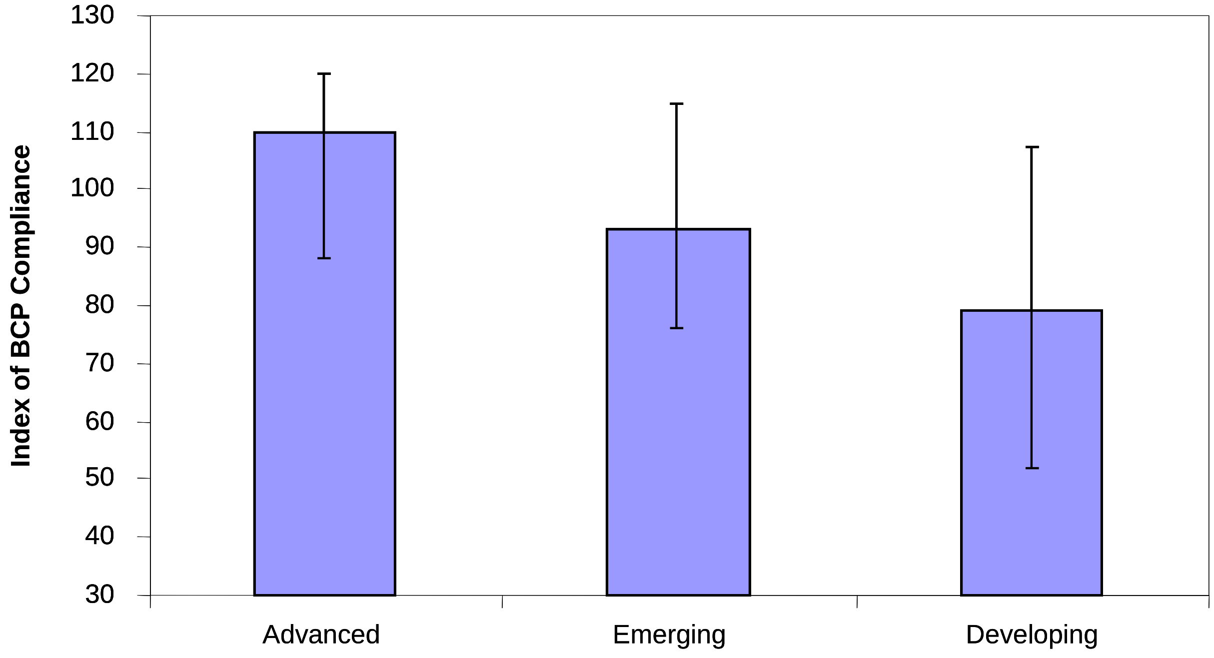
disclosures by financial institutions to provide both the comprehensive overview of an individual financial firm's health and risk profile, and the relevant country or industry segment detail sufficient to meet the needs of host country supervisors, depositors and counterparties. Country detail in many cases would remain at a level of aggregation sufficient to protect proprietary positions. One conceivable approach is creation of an electronic financial statement and disclosure document that could use spreadsheet presentation tools for financial and risk information and would allow more drilling down into the details at lower levels of aggregation. Improved disclosure creates a presumption of openness even when financial institutions are experiencing distress, as US banks found during the banking problems of the early 1990s.

Whether coordination is facilitated through supervisory information-sharing arrangements or enhanced public disclosure, or both, the larger role for foreign-owned, complex financial organisations diversified by geography and product segment creates new challenges for host country supervisors. Robust legal, accounting and regulatory frameworks in the host country facilitate supervisory coordination and information flows by reducing the uncertainty about information, actions and impact. Adoption by emerging market countries of international principles and standards promulgated by organisations such as the Basel Committee on Banking Supervision and the International Accounting Standards Board contribute to further improvement. Host country supervisors also need to understand foreign legal, accounting and regulatory frameworks in order to assess the financial health of the parent and the obligations and constraints imposed by the home country on the parent.

While good practice is advancing within the global supervisory community, there is room for continued improvement. The International Monetary Fund (IMF) has developed an index of compliance with the Basel Core Principles for Effective Banking Supervision which illustrates the opportunity for further improvement in the emerging and developing economies (Chart 5). In addition, supervisors in both the emerging markets and advanced countries face the need to enhance continually the financial and technical skills of examiners and supervisors.

Chart 5

Compliance with Basel Core Principles



Error bars denote maximum and minimum observations.

Source: Richard Podpiera, "Does Compliance with Basel Core Principles Bring Any Measurable Benefits?" (IMF Working Paper WP/04/204).

The third concern is the loss of information to the host country financial system and its financial authorities through reduced public disclosure. Market discipline based on the availability of public information about financial institutions is an important potential pillar of financial stability. Supervisors in host countries where the level of foreign ownership is high discern an impact from the delisting of large local financial institutions that constitute a major component of local stock exchanges. The corresponding reduction of local analyst coverage decreases the richness of analysis in the local market. Global analysis of the parent is unlikely to focus in a detailed and consistent manner on each country in which a multinational financial institution is active.

While not necessarily a private loss to the shareholder, since the reduced coverage may reflect the financial institution's diversification of income and exposure, reduced disclosure and analysis may represent a social loss, since the information formerly available allowed nonshareholders and regulators in the host country to assess broadly the financial health of participants in local markets and incorporate this information into the price discovery process for equities and other financial instruments. Both contribute to market liquidity. An interesting question is whether financial statements and financial and risk disclosures built around comprehensive, consolidated measures and substantial drill-down capability to more disaggregated information could fill this gap.

Foreign direct investment by its nature is a medium- to long-term commitment to participate in the financial system complemented by a commitment by the host country to a business and regulatory environment. Host country authorities desire a commitment by financial institutions to serve the local market well and to comply with local laws and regulations. Foreign financial institutions seek a commitment to market-friendly policies and stability in legal, accounting and supervisory frameworks.

What incentives are available to achieve that stability and alignment? Adherence to international standards can increase transparency around the process of reform and transformation in emerging market financial systems. To that end, the Financial Sector Assessment Program and the Reports on the Observance of Standards and Codes are two products of the IMF and the World Bank meant to provide a consistent, independent appraisal of progress in meeting the standards promulgated by the major international supervisory forums. At the same time, the responsibilities of financial institutions to local authorities and to the public are clearer and aligned with responsibilities in other jurisdictions in an environment based on common standards.

Accession to regional compacts such as the European Union or the North American Free Trade Association provides similar incentives. Such compacts can provide an incentive for the adoption and maintenance of a strong legal, market and regulatory infrastructure by making meeting standards a membership requirement. Other arrangements, such as the creation of a common financial market, as is being considered in Asia, offer a similar opportunity to create incentives for strong infrastructure practices. As in the case of adherence to international standards, the responsibilities of foreign financial institutions can be clearer and more comparable to their responsibilities in other markets when the infrastructure practices are strong.

Financial globalisation, and FSFDI in particular, continues to be an important dynamic force reshaping both financial practice and financial policy. Some questions worth pursuing in the panel discussion or in future research include:

- What are the main factors behind differing degrees of openness to foreign direct investment in the financial sector in emerging market countries? What lessons can be drawn from recent experience in host countries?
- What are the appropriate goals and behaviours of financial institutions making and managing direct investments? How do financial institutions balance local and parent interests?

- What role can market discipline play in ensuring that the interests of all stakeholders are considered by the management of global financial institutions?
- What implications does growing globalisation have for supervisory policy?
- What frequency and quality of disclosure is desirable? What improvements are needed in the accounting infrastructure?

Globalisation and convergence on the *shareholder value* model in European banking

David T Llewellyn[1]

Banking systems in Europe are facing powerful pressures of structural change and, in many ways, European banking industries are in a phase of transition. The following discussion focuses on three particular aspects of structural change: the relative role of markets and banks, the changing business ethos of banks, and corporate governance implications of structural change.

When considering the future evolution of European banking in the context of increased financial globalisation, a key issue is whether there will be a convergence of national systems such that a truly European financial system will emerge. If there is to be a degree of convergence, the question arises upon which model convergence will take place, and in particular whether it will be on the so-called Anglo-Saxon model, implying an enhanced role for financial markets and primacy given to shareholder value as the ultimate (even exclusive) business objective of financial firms. This might imply, for instance, a shift away from the bank-based model that is a feature of many European countries towards a more market-based system, a greater focus on shareholder value in bank strategies, a trend towards more "arms- length" banking with respect to the relationship between banks and their corporate customers, and changes in corporate governance arrangements to those more suited to a shareholder value focus.

Three main dimensions along which European banking systems currently differ can be identified, although care is needed not to make the distinctions too stark, as in practice all national financial systems are hybrids: (1) between *bank-based* and *market-based* models, (2) in the business ethos and in particular between Shareholder Value (SHV) and Stakeholder Value (STV) models, and (3) in corporate governance arrangements. The first two dimensions both have important implications for the third as optimal corporate governance arrangements in any system need to be consistent with the objectives and business ethos of companies.

Globalisation

The focus of this conference is on the globalisation of banking and financial markets and its implications. For purposes of the remarks to follow (related to how banking markets are likely to develop in Europe), the key characteristics of globalisation may be summarised as follows:

- Borrowers, lenders and investors increasingly have global options with respect to the source of funding and the allocation of funds and savings.
- As a result, the geographical domain of financial intermediation has widened and has become increasingly global. In its extreme form (not yet achieved), the global financial system can be viewed as a set of financial markets, exchanges and institutions which trade in financial instruments and channel world savings (wherever they are located) to investment wherever the risk-adjusted rate of return is

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considered to be greatest. In this way, financial institutions and markets intermediate in business between agents irrespective of their location or that of the institution or market. While the bulk of financial intermediation is still conducted within the domain of national financial systems, this proportion is decreasing and, at the margin and especially for the corporate sector, global options have become increasingly available. In principle, this should raise efficiency in the allocation of financial resources in the global economy to the extent that savers, borrowers and institutions have wider options and are not restricted to domestic options.

- Financial firms also locate outside their own country and conduct intermediation business for foreign local, domestic and international customers.
- Financial innovation (the creation of new financial instruments, markets and facilities) spreads quickly on a global basis.
- Shareholdings of both financial and industrial or commercial companies are becoming increasingly international in that, over time, the proportion of shares of major banks and financial enterprises that is owned outside the country has been rising steadily.
- Various forms of arbitrage between financial markets and institutions take place on a global basis.
- Financial markets and institutions are not only in competition with each other, but face increasing competition from outside their domestic countries. This is especially the case in the market for corporate and wholesale business but, to some limited extent, also in retail business.
- Shocks are transmitted internationally.
- Market discipline has been enhanced, and the market in corporate control (the mergers and acquisitions market) has increasingly become international in the financial sector and again relates both to financial institutions and to markets: witness cross-border mergers and acquisitions in the banking sector and also in securities markets.

Globalisation has wider dimensions than those described above. However, the characteristics of globalisation that have been highlighted are those that are particularly relevant to the discussion that follows about the role and business operations of banks. The following sections consider the three dimensions noted at the outset that differentiate financial systems in Europe.

1. Bank-based v market-based systems

Differences exist between countries with respect to whether financial systems are essentially bank-based or market-based. The distinctions are not rigid, however, because in practice economic arrangements in individual countries are complex, and the detail varies considerably between countries. As no country is a “pure” model, there is a danger of drawing distinctions that are too stark. Nevertheless, with this important qualification, two broad models can be identified. In what has been defined as *bank-based* systems (eg Austria, Denmark, Finland, Germany, Italy, Portugal, Spain and, to a lesser extent, France, the Netherlands and Sweden), emphasis is placed on the influence of banks, and bank financing of companies tends to be more dominant relative to capital market funding. There tend to be close bank-customer relationships even to the extent of banks having equity stakes in their corporate customers. Required information disclosure tends to be less onerous, and companies are often less transparent than in market-based systems which rely on publicly available information rather than private information made available to bank lenders. Ownership is often close in such countries, and shareholder rights tend to be more limited than in the Anglo-Saxon model, with voting rights often not being directly proportional to the size of ownership stakes.

The main differences with respect to corporate governance relate to the extent to which shareholders are able to hold the management of companies to account, and the rights and power of shareholders. There is a greater tendency towards "inside" governance arrangements in bank-based systems, and the management teams of companies tend to have more power relative to external owners. Market discipline on banks and corporations tends to be less strong than in more market-based systems, and the market in corporate control tends to be less pronounced. This in turn seems to imply differences in corporate governance arrangements. To the extent that such systems are often more STV- rather than SHV-based, more interest groups have influence on the business strategy of companies.

In contrast, in more market-based systems (such as - in Europe - the UK and Ireland) bank financing tends to be less dominant, the ownership of companies tends to be more dispersed, shareholders have more power enshrined in clearly defined and explicit ownership rights, and there is a greater requirement for information disclosure. The relationship between banks and their corporate customers tends to be more "arms-length" than in more bank-based models. With respect to influence and control, the capital market tends to be more powerful and the market in corporate control is more active, especially with respect to the possibility of hostile bids. Of particular importance, the business objectives of companies tend to be more unambiguously focused on shareholder value criteria.

Differences between countries in the role of capital markets stem, in part, from the legal environment not the least because investor confidence is partly a reflection of the type of protection offered by the law. As noted by Franks (2006), "…differences in legal protection to investors can explain important cross-country differences in the size of capital markets, and the financial policy of listed companies". In general, common- law countries (as opposed to countries with a civil-law tradition) tend to offer more protection to investors, to have larger capital markets, and to be more shareholder value- orientated. They also tend to have more dispersed shareholding of companies and corporate governance arrangements conducive to shareholder value, with clearly defined shareholder rights, including voting rights proportional to the size of ownership stakes.

However, while there are differences between the two models, the dichotomy is not rigid. In practice, all systems have a varying mix of bank-based and market-based characteristics. The differences relate to degree rather than kind. In particular, the development of securitisation of bank loans, the funding of bank loans through capital market issues, the growing use of derivatives contracts and the trading of such contracts as a means of managing bank risks, and more active securities trading by banks mean that what might once have been a clear distinction between bank-based and market-based financial systems is no longer clear- cut. To this extent, there has already been a degree of convergence, which is a central theme of this paper.

Possibly the most significant development eroding the distinction is the emergence of credit derivatives. In some areas, credit risk is being shifted from originating banks' balance sheets to capital markets and other institutions as credit risk is repackaged and redistributed. Thus, a distinction is made between the origination of a loan (by a bank) and where the credit risk ultimately resides, in that, while a loan might be retained by the bank as an asset, the credit risk may be passed to others. Credit risk can be stripped out and made into a tradable commodity in secondary markets and, in the process, risk is becoming commoditised and traded in global markets to some extent.

Markets in the ascendancy

A central theme is that, over time, markets are likely to become relatively more important than institutions (banks) in the financial intermediation process. Several factors are likely to enhance the relative role of markets as compared with banks in European financial systems over the coming years, of which an overwhelming factor will be the further globalisation of financial markets. The development of the euro capital market is likely to accelerate, which will further enhance the depth and economies of scale in having, for the first time, a single European capital market without currency and exchange-rate barriers. The growing institutionalisation of fund management (eg, through the growth of pension funds) is also likely to enhance the role of markets in Europe. To the extent that capital adequacy and other regulations impose additional costs on banks, arbitrage might further enhance the role of the capital market, especially with respect to securitisation and the funding of the corporate sector. Factors internal to capital markets (such as the further sophistication of information and communications technology), and the dynamics of financial innovation, are likely to enhance the competitive position of financial markets and have the potential to take business from banks.

The next section argues that shareholder value is likely to become a more central feature of bank strategies, which in itself may change the relative roles of banks and markets in Europe. In some countries, banks that have traditionally been less SHV-focused than others hold assets on the balance sheet which do not strictly conform to shareholder value principles. To the extent that, at the margin, banks exit this business, some corporate loans that have traditionally been on the balance sheets of banks may gravitate to the capital market.

2. Shareholder v stakeholder value

Unlike in other industries, banking systems in Europe are populated by a variety of different types of banks with a varying mix of public, State, cooperative, mutual, and private banks. There is no homogeneity and this extends, for instance, to how different classes of banks define their ultimate business objectives. In this last respect a distinction is made between what might be termed Shareholder Value (SHV) and Stakeholder Value (STV) banks.

There is no universal view in Europe about the role and objectives of companies and in particular whether, as in some continental countries, the company is viewed as a social institution that exists for the benefit of many types of stakeholders, or whether (as in the stereotypical Anglo-Saxon model) it is essentially a financial entity with primacy given to the shareholders/owners of the company who are the ultimate suppliers of risk capital. This distinction encompasses different views about who are the relevant stakeholders, the relative role of shareholders in the stakeholder mix, the clarity of the bottom-line objectives of companies, and the exclusivity of the profitability objectives of companies. It also has implications for the role of capital market discipline on companies and of the market in corporate control, which tends to be greater in SHV than in STV regimes. The nature of the distinction is illustrated by a recent comment made to the *Financial Times* by Ferdinand Piech (Chairman of the Supervisory Board of Volkswagen and a member of the family that controls the Porsche company):

> "Yes, of course, we have heard of shareholder value. But that does not change the fact that we put customers first, then workers, business partners, suppliers and dealers and then shareholders".

The distinction between STV and SHV models is ultimately about the bottom-line business objectives of banks. While the distinctions are in practice complex, the SHV model is based on the notion that banks (in fact, any firm) exist primarily to maximise shareholder value and hence the rate of return on equity. Shareholders are the owners of the bank and the ultimate risk-takers. In contrast, in the STV model there are many stakeholders in a company of which shareholders are only one. In the STV approach, while profitability is one of the objectives of the bank, it is not necessarily the exclusive, or even primary, objective. It is more an issue of balancing the different interests of the various stakeholders in the company. In practice, this means that an STV bank will not pursue profit maximisation to the same degree, or with the same intensity, as will SHV banks (Llewellyn, 2005). Crockett is emphatic about the nature of a bank's bottom-line objective:

> "increasing shareholders' value has to be the ultimate objective of all banks….In Europe there are a lot of institutions for which profitability is not a primary objective". (Crockett, 2004)

Stakeholder Value banks can be either banks which are not incorporated (eg, mutuals, cooperatives, State-owned, etc) or private banks which either choose or are forced to pursue strategies other than the maximisation of shareholder value. Particular examples of the first type include Landesbanks and Savings Banks in Germany, which are not owned by shareholders whose equity holdings can be bought and sold in the secondary market. The tradability of ownership stakes is a key area of difference between SHV and STV banks. In other European countries, banks may be State- (or semi-State-) owned, or may be cooperative banks, again with no explicit ownership of shares that can be traded in the market. This implies, for instance, that such banks would not be subject to capital market pressure to anywhere near the same degree as avowedly SHV banks. In contrast, in the UK all banks are SHV institutions, there being no State banks and only a small number of mutual bank-like institutions (building societies) whose market share is, in any case, very limited, as regulation limits their allowable range of business activities. In the UK, STV institutions compete in only a small number of banking markets, mainly savings and mortgages.

In some European countries, banks have been earning negative economic value added in that, while the rate of return on equity (ROE) has been positive (although sometimes very low), it has often been less than the cost of capital. The characteristics of a true SHV bank are outlined in Llewellyn (2005). Although something of a caricature, the ROE is partly exogenous in an SHV bank (in that an explicit target is set and business decisions are made in that context), whereas it is largely endogenous in an STV bank (in that the bank decides on its business strategy and the rate of return on equity results from that). Although this is an extreme representation of the differences between banks, the differences in degree are significant. For instance, British banks (which are avowedly SHV-orientated) have been more prepared to securitise assets and repay the resultant excess capital to shareholders than have banks in other European countries. The assets that are securitised have been profitable, but not sufficiently so to meet the established target rate of return on equity.

The UK is close to unique in Europe in having an almost exclusively SHV-based banking system: it is at one end of a spectrum. Most European countries have a mixed system of both SHV and STV banks with the market shares of the two sectors varying considerably between countries. There is empirical evidence that the size of the STV sector in a country has an influence on the profitability of banks, in that the higher the proportion of banking business in a country conducted by STV banks, the lower the profitability (ROE) of SHV banks tends to be (Llewellyn, 2006). It seems that a significant presence of STV banks in a financial system constrains the income-generating and pricing power of SHV banks. In some countries, STV banks receive benefits which enhance their competitive position in the marketplace: to the extent that they are State-owned, they are perceived to be bankruptcy-free and to have a lower cost of capital. They may also receive capital injections from their owners on non-market terms, as well as other State subsidies, although these are scheduled to be phased out under EU Commission pressure. In Germany, for instance, the evidence suggests that the often low profitability of private banks is associated more with weak income generation than with excessive costs (Maier, 2006).

A case study of the UK

British banks, accepting the ultimate logic of such business strategies, have adopted avowedly SHV strategies for a longer time, more consistently and more aggressively, than have banks in many other European countries. The aggressive adoption of the SHV approach is partly a reflection of the economic and financial reforms made in the UK during the 1980s.

As British banks represent an extreme form of SHV-orientation within Europe, it is instructive to consider the profitability experience of British banks as a case study of the implications of pursuing explicit SHV strategies. In general, British banks have had higher ROEs and excess returns than banks in other European countries. The relatively superior performance of British banks is considered in Llewellyn (2005) and in Quignon (2000 and 2005), who also observes that this cannot be ascribed to these banks having lower equity-asset ratios as they are amongst the highest-capitalised banks in the world.

Our theme is that, to some extent, British banks have been very profitable partly because they have chosen (or have been forced by capital market pressure) to be profitable. Structural conditions in the UK have also been supportive of banks adopting an SHV strategy: these include, for instance, flexible labour-market laws, the absence of STV banks, and only a limited mutual sector in competition with banks. In addition, the benign business cycle since the early 1990s has reinforced the profitability of banks compared with some other European countries, especially Germany.

Several features of British banks indicate the emphasis given to SHV strategies: costs and employment have been reduced substantially; branch closure programmes have been extensive, with the number of branches per head of the population now being the second lowest in Europe; unprofitable (or low profitability) businesses have been sold; banks have exited from unprofitable (or low profitability) business areas; they have securitised assets on a significant scale, and several banks have withdrawn from investment banking and divested some foreign-based operations that have been "deemed not to be profitable enough" (Quignon, 2000). He argues further that "major British banks are reaping the benefits of the refocusing and rationalisation strategies implemented during the 1990s" (Quignon, 2005).

Several of the largest banks have repaid capital to shareholders not only through high dividend payouts, but also through buying back equity from shareholders. This is not, however, exclusive to the UK; for instance, Deutsche Bank has also made repayments of capital to shareholders. Some British banks have simultaneously securitised assets and repaid capital. This might seem prima facie to be a perverse strategy in that securitisation creates excess capital which is then returned to shareholders. Banks have securitised assets not because they have faced a capital constraint but because, by implication, the rate of return on securitised assets, while positive, has been below what has been needed to meet the target ROE established by the bank.

British banks have also been active in changing the organisational structure of their business. In particular, and in order to manage costs, substantial outsourcing has been undertaken which implies banks ceasing to do internally what traditionally has been regarded as part of their core business. A significant proportion of processing, for instance, has been outsourced. One (though not exclusive) motive has been to gain the cost advantages of economies of scale with banks effectively buying in economies of scale that they cannot generate internally. It also has the advantage of lowering banks' fixed costs (Llewellyn, 1999).

All this means that, when comparing British banks with banks in many other European countries, and because British banks have followed a more aggressive SHV strategy, they have been prepared to do what banks in many other European countries have not been prepared to do (eg, securitise assets and simultaneously repay capital), and have not done what others have done (eg, maintain low rate-of-return assets on the balance sheet).

Several factors explain the more aggressive SHV strategy of British banks compared with those in some other European countries. Firstly, it is partly a reflection of general cultural differences: the SHV focus of the Anglo-Saxon model compared with the more general STV model exhibited in some other European countries. Banks in some European countries do not always believe that maximising the ROE is their principal or overriding objective. Secondly, there has been no legacy effect in the UK from previously State-owned banks which have not pursued SHV strategies and which, through market distortions, have inhibited private banks from rigorously pursuing such strategies. Thirdly, with the exception of mutual building societies, there is no strong mutual or cooperative banking sector in the UK and no semi-State-owned banks. This means that there are no significant STV banks in the UK. Fourthly, in some countries there have been legal and regulatory limits to, for instance, securitisation and the repayment of capital, which do not exist in the UK.

Above all, the power of the capital market has been substantial and more pervasive than in many other European countries. To some extent, banks have been maximising SHV in order to maintain a high share price in the market; so as to simultaneously make them less vulnerable to hostile take-over bids and also increases their own power to proactively engage in take-over activity. It is noticeable that, in general, there is a more active market in corporate control in the UK than in most other European countries. This again is a more general feature of the so-called Anglo-Saxon model.

Convergence on the SHV model

A key issue is the extent to which there will be convergence in Europe on the shareholder value model and a possible confrontation between this and the stakeholder value model. The juxtaposition of these two contrasting models is almost unique to the banking industry in Europe, although it varies between different countries because of differences in the mix of the two types of bank. For instance, a high proportion of banking business (over 50 percent) in Germany is conducted by STV banks, whereas in the UK the proportion is minimal and restricted almost exclusively to savings and mortgage lending business to the personal sector.

Our thesis is that, in the years to come, profitability will become a more central issue in European banking and this will focus on concepts such as the rate of return on equity, economic value added, excess returns, earnings per share, etc. These are likely to become more important and central imperatives in European banking than has been the case in at least some European countries in the past.

In the context of increasing globalisation, several pressures are likely to enhance the trend for European banks to give more emphasis to SHV strategies:

- Globalised competition, with European banks being forced to compete in global financial markets and with banks orientated to shareholder value, is likely to produce a degree of convergence on business criteria.
- Banks face global competition for capital because investors (especially given the growing importance of institutional shareholders) have choices over where to invest.
- The shareholder base of European companies (including banks) is becoming increasingly international with a growing proportion of ownership stakes being held by investors (including institutional shareholders) with an SHV focus.
- For these and other reasons, shareholders are likely to become more active in the governance arrangements of European firms, including banks.
- The governance reforms introduced in many European countries are also likely to increase the demands for accountability to shareholders, including to those who have an SHV focus.

- For reasons outlined earlier, the capital market is likely to impose more discipline on management to deliver shareholder value. The evaluation of bank performance through global equity markets will produce greater incentives to adjust business strategy according to SHV criteria.
- As part of this, the development of a more active market in corporate control will increase pressure on bank management to focus on shareholder value as it has in so-called Anglo-Saxon countries' business models.

The overall conclusion is that banks in continental Europe are likely to come under increasing pressure to focus on shareholder value considerations in their business models.

3. Corporate governance arrangements

The third dimension noted at the outset relates to corporate governance. The trends we have outlined have implications for corporate governance arrangements in European banking because optimal arrangements need to reflect the structure and ownership of firms and their ultimate business objectives. Corporate governance arrangements and structures vary considerably between countries, as does the power of the capital market and the market in corporate control to exercise discipline on bank management. Consideration needs to be given to corporate governance implications of any convergence that might take place on the SHV model in banking.

As already noted, there are substantial differences between European countries with respect to corporate governance arrangements and the power of the capital market to impose discipline on the management of companies. The differences relate to such considerations as the rights of shareholders, the structure of voting rights and the extent to which rights are proportional to the size of ownership stakes, the level of shareholder activism, the rights of minority shareholders in companies, the extent of cross-shareholdings between companies, the degree to which ownership in companies is concentrated or dispersed and the extent of institutional shareholdings, the structure and limitations of voting rights, the disclosure regime, varying degrees to which outsiders are able to monitor and control inside managers of companies, and the extent to which take-over defences are in place.

Without making the distinction too stark, a comparison can be made between what might be termed a stereotypical continental model of governance and the so-called Anglo-Saxon model. In the continental model, ownership tends to be close, with a small number of shareholders owning substantial blocs of shares. Insider management control tends to be more powerful, and there are often limits to shareholder rights including voting rights. It is not uncommon in some European countries for voting rights to be disproportional to the size of ownership stakes. Cross-shareholding is also more common. Furthermore, the market in corporate control tends to be less active partly because defences against hostile take-overs are often in place. Disclosure requirements are often less onerous in the continental model than in the Anglo-Saxon model. Overall, there tends to be less of an exclusive focus on shareholder value.

In contrast, the Anglo-Saxon model tends to have more diffuse ownership structures of companies (including institutional investors) and shareholder rights tend to be more clearly defined, with, for instance, voting rights proportional to the size of ownership stakes. Partly because the market in corporate control is more active, there tends to be a greater focus on shareholder value in business strategies.

There is currently no convergence in corporate governance arrangements in European countries. The comparatively lower degree of investor protection in civil-law countries allows entrenched management to protect themselves from markets in corporate control by using such devices as pyramids, non-voting shares and poison pills. As noted by Franks (2006), "The result is that the objectives of profitability and shareholder wealth maximisation have been given a low priority". The view of Ferdinand Piech was quoted in an earlier section. It is interesting to note that he is a member of the family that controls the Porsche Company through shareholdings that comprise 50 percent of the capital but 100 percent of the votes.

However, several countries (notably France, Germany, Italy, the Netherlands, the Nordic countries and Spain) have recently been making changes, and generally making governance arrangements more explicit. Several reforms have been made which move governance arrangements in the direction of SHV principles, including reform of accounting standards and the protection of minority shareholders' rights. In Germany tax changes have been designed to reduce the extent of cross-shareholdings. In other areas, corporate governance practice has not kept pace with the ambitions to develop a European capital market, and further reforms will be needed and are expected to emerge. Overall, corporate governance issues are coming to be taken more seriously. In an interview with the *Financial Times* (17 October 2005), EU Commissioner McCreevy indicated that the Commission will seek to eliminate discriminatory treatment of shareholders by introducing the rule of "one shareholder, one vote". This would represent a major change to the corporate governance arrangements of many large European companies. A recently issued EU Directive has focused on shareholder rights.

Concluding remarks

There has already been some convergence and a more pronounced focus on SHV models (and their corporate governance implications in Europe) in several respects: the share of capital market financing of the corporate sector has risen in several European countries along with a loosening of the traditional strong relationship between banks and their corporate customers; the development of the capital market is seen in the growing significance of securitisation; a greater diversity has emerged in the investor base of banks and companies, including a greater internationalisation of the investor base; reforms of company accounting rules have been made; there have been some moves towards so-called Anglo-Saxon corporate governance arrangements; take-over activity has increased; previously State-owned banks have been privatised, and there have been moves away from the tradition of cross-shareholdings in some European companies. In some respects, the capital market has come to exercise a more powerful discipline on companies, and the market in corporate control has developed further.

All of this has, in turn, raised corporate governance issues as shareholder activism has increased. In Germany, for instance, there has been a significant increase in the international shareholding of large companies spurred in part by the increasing harmonisation of European regulation, and the substantial unwinding of cross-shareholdings between companies. Such institutional shareholders are likely to adopt a more SHV approach to corporate governance. Disclosure requirements have been intensified in several countries, shareholder rights have been strengthened in those countries where historically they have been weak, and the capital market and the market in corporate control have come to exercise more market discipline.

Increased competitive pressures and the impact of globalisation in financial and banking markets are likely to produce a greater focus on profitability in European banking. As a single example, Deutsche Bank now has a public target of 25 percent for its rate of return on equity. The OECD (2004) reports that "an increased emphasis on the shareholder value paradigm is a fact of life for most financial firms". These trends will in turn have implications for bank strategy.

The central theme has been that, in many European countries, financial systems will change significantly in three major respects: a rise in the relative role of markets, a shift towards increased SHV orientation, and changes in corporate governance arrangements. If this proves to be the case, the business of banking in Europe will change significantly as the full implications of SHV strategies become apparent. The strategic implications of this could be substantial. It could represent something of a paradigm shift in European banking.

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Global banking: trends and policy issues – a host country perspective

Guillermo Ortiz

There is ample agreement about the benefits that the free movement of goods and capital brings to economies, as well as the advantages of opening up economies to foreign investment. But when it comes to real decisions, this concept stands firmer in theory than in practice. There are many developed countries which, despite the rhetoric of open markets, are still somehow reluctant to open up certain sectors that they deem to be strategic.

Countries might have different reasons for considering a particular sector as strategic to their national interest. However, if there is one sector that should be regarded as strategic, that sector is banking. Banks are special: they are the nervous system of the economy. They provide access to the payment system and benefit from a specially-designed safety net. However, the need to attract capital after a major banking crisis, or to privatise the system after the fall of communism, has forced many countries in Latin America and Eastern Europe to allow the entry of foreign investment into their large banks.

The benefits of foreign direct investment in the financial system, as well as some of the challenges, are well described in the study carried out by the Committee on the Global Financial System (CGFS) under the chairmanship of Christine Cumming.

I would like to comment on two particular challenges that host country authorities face when foreign investment is concentrated in their large retail banks: first, I on the impact of foreign bank entry on the efficiency and competition of banking systems, and second, the impact of the way in which global banks are managed on subsidiaries' ability to stand alone and on market discipline. Finally, I would like to suggest some policy options. Regulatory and accounting differences are also an important challenge; However, since Christine has referred to these issues more extensively, I will skip these points.

I. The impact of foreign bank entry on the efficiency and competition of banking systems

The foreign exchange crises and sovereign defaults of the 1980s persuaded banks to mitigate the cross-border and exchange rate risks by funding loans in the countries where they intend to lend. This change has been accompanied by an emphasis on developing the profitable consumer banking industry. However, to reach the profitable household sector, banks require a local depositor base. Thus, the expansion of global banks is taking place mainly through the acquisition of existing financial entities rather than the establishment of new ones. This situation leaves host country market structures largely unchanged. Improvements from foreign investment are tangible in many aspects of banking, such as the introduction of new products and technologies, a more competitive allocation of commercial credit, improved risk management and the development of the derivatives and money markets. But efficiency gains in other sectors very often result in higher profits rather than consumer benefits.

Comparisons between interest rates or bank commissions in different countries are hard to perform. The banking industry is characterised by the cross-subsidising of products and services, and also by indirect pricing. In other words, prices of individual services do not usually reflect their underlying costs. Additionally, institutional arrangements are not homogeneous across countries, and consumption patterns are heterogeneous, adding a degree of complexity to international price comparisons. However, in general, banks' interest rate margins and bank commissions are often much higher in host countries than in countries where parent banks are incorporated.

Just to mention some examples:

- In Mexico, interest rates on credit cards are above 32%, when annual inflation is close to 3%.
- The maximum interchange fee for a credit card transaction is 1.95% in Mexico and 1.4% in Spain.[1]
- Interchange fees for debit cards have a ceiling equivalent to one euro in Mexico, while in Spain the ceiling is 0.53 euro.

Higher interest rate margins in host countries are partly explained by the fact that interest rates are still higher in the countries, reflecting higher country risk. Also, subsidiaries tend to extend more credit to the household sector where margins are higher. It is also clear, however, that competitive pressures are insufficient. Otherwise, these high charges would tend to come down, and we have not seen that clearly.

The benefits from globalisation are not automatic. Host country authorities have to take measures to improve competitive conditions in their markets. On the competition front, Banco de Mexico has taken a series of steps to increase market competition, particularly regarding consumer lending and payment systems.

Some of the measures taken are:

- Requiring banks to publish annual interest rates (APR) and to disclose fees and commissions;
- Prohibiting banks to charge each other commissions for sending or receiving customers electronic transfers;
- Publishing on the central bank website of simulators to allow consumers to compare interest rates;
- Efforts to reducing banks' interchange and discount fees in credit and debit card payments.

In sum, we have so far taken measures to increase transparency and information, while refraining from direct regulation.

II. The impact of the way in which global banks are managed on subsidiaries' ability to stand alone and on market discipline

Now, I would like to comment on the challenges that host-country authorities face when foreign investment is concentrated in their large retail banks. In particular, I will focus on the impact of foreign bank entry on the subsidiaries´ ability to stand alone and on market discipline.

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[1] Ministerio de Industria, Turismo y Comercio de España. Acuerdo entre las Asociaciones del sector comercial y las entidades de crédito para la reducción de las tasas multilaterales de intercambio en los pagos realizados con tarjeta. Diciembre de 2005.

The main challenges that host country authorities face do not have anything to do with the nationality of their banks' shareholders. They arise from the discrepancy between the way in which global banks are managed and the legal and regulatory frameworks that govern their activities. This discrepancy leads to an uneven division of decision-making powers and responsibilities between parent banks and subsidiaries and between home and host country supervisors.

Subsidiaries' ability to stand alone

The way in which global banks are managed can lead to decisions that are good for the global bank but not necessarily for the subsidiary or the host country. Global banks are often organised along business lines. Their capital and business are managed and allocated on a portfolio basis, according to where they expect higher risk-adjusted returns and where negative correlations can help them to attain higher expected profits. Decisions taken at the global level could benefit some subsidiaries and hamper others. There is also a growing tendency to book transactions where funding and regulatory costs are lower. Although this makes sense from the global bank's perspective, it shifts revenues away from the local bank where the business originates. Global banks also establish individual limits to credit exposure in each foreign country according to the sensitivity of the overall portfolio. Thus, subsidiaries sometimes have to reduce their local exposures, even though these exposures are also financed locally. Global banks are also inclined to adopt matrix reporting arrangements by which local treasurers, comptrollers, and risk managers report directly to parent bank heads rather than to the local CEOs. These arrangements weaken the accountability of the subsidiaries' officials.

The extent to which a global bank centralises its decision-making processes depends on its degree of control over its subsidiaries, the relative size of the subsidiaries, and their own practices. The degree of control over a subsidiary is closely related to its ownership structure.

The ownership structure of subsidiaries

It is generally accepted that widely held ownership structures are convenient for large banks, as they make it more difficult for controlling shareholders to take decisions that may not be in the best interest of other stakeholders. In fact, some countries have set limits that restrict the percentage of shares that a single shareholder can acquire, as Canada still does for its larger banks.

The acquisition of local banks by foreign entities often involves the elimination of minority shareholders; at least that has been the case in Mexico. When the decisions made by the parent bank are expected to have important consequences for the host country economy, the subsidiaries' ownership structure and corporate governance practices become relevant for the local authorities.

Market discipline

The need to encourage market discipline to supplement the work of supervisors is widely recognised at the international level. However, for market discipline to work, market participants need signals in the form of prices that reflect market perceptions, instruments to enforce discipline, and research carried out by independent analysts.

The acquisition of local banks by global financial entities often results in the delisting of local banks from stock exchanges. When financial institutions are not listed or do not have a reasonable amount of subordinated debt outstanding, market participants are deprived of information.

III. Policy options

I would like now to discuss some policy options for aligning incentives at the subsidiary level.

Ability to stand alone

The relevant question is: how can we create the right incentives to entice managers of large subsidiaries to put subsidiaries' interests before those of the controlling shareholders?

Disclosing more information

The obvious regulatory response to the delisting of stocks would be to require subsidiaries to disclose the same amount of information that they would disclose if they were listed. However, publishing information by itself will not lead to greater market discipline and to a realignment of local incentives.

Strengthening corporate governance

Another policy option could be to establish a legal obligation for local managers and board members to act in the best interest of the subsidiary. The Reserve Bank of New Zealand has moved in this direction by establishing that bank directors should not act in the interests of the holding company when their actions are detrimental to the subsidiary. Nevertheless, local bank directors and board members are often long-serving employees of the parent bank. Their interests and professional careers are more aligned with the interest of the controlling shareholder than with the subsidiary's. Moreover, as mentioned before, matrix reporting arrangements weaken the accountability of subsidiaries' officials.

Issuance of subordinated debt

Many academics have suggested the idea of requiring banks to issue subordinated debt in order to increase market monitoring and exert influence over bank managers.

However, subordinated debt yields are determined by at least two factors: the market view of the subsidiary's soundness and the likelihood that its parent bank will support it if trouble arises.

If market participants believe that parent support is likely to materialise in the event of trouble, then subordinated debt yields do not reflect the subsidiary's risk-return profile.

Widening the ownership structure of large subsidiaries

The best solution seems to be to widen the ownership structure of large subsidiaries. Having minority shareholders sit on the boards of important subsidiaries would encourage decision-making in the subsidiaries' best interest, benefit corporate governance and give meaning to the role of independent board members. Of course, the participation of minority shareholders should parallel the strengthening of regulations to protect their rights, a path many countries, including Mexico, are already taking. The presence of minority shareholders on subsidiaries' boards would facilitate the listing on stock exchanges of systemically important subsidiaries. A public listing provides market participants with price signals and instruments for exercising discipline.

It has been argued that local markets often lack sufficient liquidity, and thus price signals would be deficient. Although I would personally like shares to be listed on local stock exchanges, market discipline may work as well if large local banks list their shares on international stock exchanges. Some argue that the listing subsidiary shares is irrelevant since subsidiaries reap the benefits of belonging to widely held parent banks. This argument ignores the legal separation between parent banks and subsidiaries. It is true that when a subsidiary's earnings account for a large percentage of group profits, the performance of the parent bank's shares will likely reflect the subsidiary's actions. On the contrary, if the subsidiary is relatively small in comparison to the parent, its behaviour will not have any effect on the underlying stock. However, having a widely held parent bank is not a guarantee that all decisions will be made in the best interest of the subsidiaries. Moreover, host country authorities cannot rely on the assumption that parent banks will always support their subsidiaries.

Final remarks

The increasing globalisation of financial markets and institutions brings many benefits to all parties involved. However, we cannot ignore the challenges that the entry of global banks represent, especially for host countries. As mentioned before, these challenges have nothing to do with the nationality of banks' shareholders, but rather derive from the discrepancies between the way global banks are managed and the legal and regulatory frameworks that govern their activities.

For host countries, it is very important to put in place the right incentives to enhance market discipline and the stand-alone ability of their large foreign-owned banks. The best solution seems to be to widen the ownership structure of large banks by requiring them to list 25% to 30% of their shares. Having minority shareholders sit on the boards of important subsidiaries would encourage decision-making in the subsidiaries' best interest.

The uneven division of decision-making powers and responsibilities between parent banks and subsidiaries, as well as between home and host country authorities, could make the interaction of central banks and supervisors very difficult, especially if trouble arises in a global bank. Conflicts between home and host country authorities will be particularly significant if the parent bank and its subsidiaries are substantially different in size. For example, home country authorities will not be very keen to support failed small subsidiaries overseas, even if they are relatively important in their respective host countries. On the other hand, host country authorities will face serious political difficulties if they attempt to use public resources to resolve a foreign-owned bank.

The lack of common or supranational jurisdictions to deal with troubled global banks complicates the attainment of reasonable solutions. The matter is further complicated by the fact that the roles and responsibilities of parent banks and subsidiaries do not mirror their legal structures.

The Basel Committee has been working actively to set principles of information sharing between home and host country supervisors. However, central banks have been left out of the picture. It is very important to devote more efforts to improving the existing frameworks for cooperation among central banks with regard to crisis management.

One possibility for encouraging efforts in this direction would be to create a CGFS working group on central bank cross-border crisis management. This group should study how the attainment of reasonable solutions in a global banking crisis could be hampered by the existence of different legal jurisdictions and roles.

Some policy lessons for emerging economies

Remarks at the policy panel

Vittorio Corbo[1]

Good afternoon. I am very pleased to be here today at this conference on such an important subject for central banks around the world. Particularly for emerging economies, growing financial integration has enormous policy implications, which I will try to review briefly.

First of all, financial integration comes as a mixed blessing for emerging market economies. Certainly, financial integration does bring great benefits to these economies: external funds begin flowing in; countries can enjoy lower costs of capital and take advantage of greater opportunities for risk diversification. In addition to cost reduction, through increased competition, it pushes local industry to increase efficiency and adopt best practices. In a more open environment, competition and market discipline are enhanced.

However, financial integration also entails the danger of amplifying the costly distortions and imperfections of domestic financial markets, as they are internationalised through financial flows between countries. It may also uncover the incompatibilities that arise between countries with inconsistent macroeconomic policies. But what is probably even more important, financial integration creates an additional source of domestic volatility, as irrational exuberance, bubbles and crashes in international markets are imported and contagion effects and sudden stop dynamics make it almost impossible to remain isolated from shocks elsewhere in the world.

Openness itself can be a source of additional volatility, if it exposes the country to upswings and downswings in world activity. Episodes of sharp price corrections can be well accommodated by large and deep capital markets, but can be difficult to deal with for small economies. Similarly, changes in perceptions or attitudes towards risks can abruptly alter the funds that a country can expect to receive (sudden stops). These changes can prove costly, in terms of sharp price variations, pressure on the exchange rate, projects having to be abandoned for lack of funding, and so on.

In such a scenario, what can small countries do? The gains from greater access to funds are big enough to put the focus on efforts to reduce the potential costs and increased risks from integration rather than on avoiding openness. Moreover, recent technological advances that have made financial transactions cheaper and easier to carry out make it difficult to manage restrictions to financial transactions. In the case of Chile, our financial openness, measured as the stock of foreign liabilities over GDP, is above Latin American and world averages.

There are a number of policies that countries can adopt to cope with increased volatility. In the macrofinancial area, the key pillars are: (1) fiscal prudence, (2) price stability and central bank credibility, (3) flexible exchange rate policy, and (4) a sound financial system.

1. With regard to fiscal prudence, the public sector in Chile has followed a self-imposed rule of "structural surplus", which anchors expectations and reduces uncertainty about long-term fiscal policies. The rule aims at a given surplus in relation to a measure of trend GDP, rather than actual GDP. This implies that, in addition to

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[1] Governor of the Central Bank of Chile.

fixing expectations, the rule reduces the procyclicality of aggregate demand in the cycle, since it induces higher savings in periods of expansion and higher expenditure as a percentage of actual GDP in periods in which output is below trend. In other words, the rule fosters the build-up of assets in good times to be used in bad times, smoothing out the cycle.

2. Moving to price stability, this is a core role of the central bank. Price stability is a necessary condition for a well-functioning market economy and for achieving high growth. A key determinant of price stability is confidence in the value of the currency, which is attained by credibility of the central bank. This, in turn, is achieved through consistent implementation of central bank policies. Credibility also gives the central bank room to implement stabilising monetary policies in bad times and ease liquidity pressures under financial stress. Also, but not less important, the central bank must seek to reduce risks in public finances and the financial system arising from the structure of financial incentives and weak regulation – i.e., currency and maturity mismatches. In other words, the central bank must also be concerned with the financial stability of the economy, a prerequisite for effective monetary policy.

3. The third key element is a flexible exchange rate regime . Chile adopted a floating regime in 1999. The main benefit of this regime is that it allows the economy to adjust to changing fundamentals, without giving rise to speculation or letting disequilibria build up. In a context of openness to international movements of capital, a flexible regime is necessary for an independent monetary policy to succeed. The financial sector has incentives to develop the instruments that private agents will demand for hedging purposes. Finally, a flexible regime does not preclude the use of international reserves to ease adjustments in extreme conditions.

4. The fourth element is a sound and deep financial system. A sound financial system is essential for supporting economic growth. In addition to the main services that it provides – intermediation between savers and investors and risk diversification – a healthy financial system enhances the efficiency of monetary policy. The key areas for a sound financial system depend on country circumstances. However, there is a broad consensus about the standard requirements for good practice, such as a well capitalised system; effectively regulated and supervised, focused on risk management; market discipline; and no barriers to new participants – in particular, foreigners.

There are, of course, areas in which the Chilean economy can further improve our resilience to external volatility. The main challenges are in corporate governance, financial infrastructure, and higher integration in international financial markets. Poor governance, in particular, lack of transparency and insufficient protection of minority shareholders, may prevent firms from being widely held and from taking full advantage of financial globalisation, even if the country erects no barriers to financial trade and has a sound macroeconomic background.

On the other hand, the financial infrastructure, defined as the set of institutions and mechanisms that permit the secure mobilisation of financial resources, should converge towards international best practices, particularly in view of increased financial activity. Deficiencies in financial infrastructure could be at the root of problems in financial systems, while also helping to propagate problems from one market or institution to others.

Finally, an important step in reducing the volatility that comes with financial integration with the rest of the world would be to increase our ability to issue debt in our own currency. This would greatly reduce our vulnerability to external shocks.

The IMF in a changing world

Raghuram Rajan[1]

Good afternoon. As this conference has suggested, the world, especially the financial world, is changing rapidly. Capital markets are becoming more integrated through cross-border capital flows, especially as the “home bias” of investors diminishes; product markets are becoming integrated through trade; and labour markets are becoming more seamless, partly through immigration but also partly through new technology that allows services to be provided at a distance. In such an increasingly integrated world, it is useful to ask what role an organisation like the International Monetary Fund can play. The question is especially pertinent as emerging markets are becoming more mature and many believe the crises that were our focus have become curious artifacts of history.

I think, if anything, the role of the IMF has become more important. Clearly, growing integration increases the possibilities of spillovers from a country’s domestic policies to the outside world. At the minimum, this entails more multilateral dialogue, but the nature of the spillovers could even imply coordinated action. A multilateral organisation like the IMF, with analytical capability , and the legitimacy that comes from its mandate and its membership, is ideally placed to help such a process. Second, even though international capital markets have become deeper and more capable of taking on risk, they are not immune to fads and fashion. A dramatic withdrawal of foreign capital from riskier emerging markets, perhaps because of a rise in industrial country rates, can still have severe adverse effects on emerging markets - pain that is not internalised by foreign investors. Fund financing can help reduce these effects. When the current benign environment turns, there will indeed be a renewed role for Fund financing. But undoubtedly many “advanced” emerging markets, while still vulnerable, have become more mature, with more sensible policies, so the Fund should revisit how it finances.

Finally, a changing world means a changing structure of economic power. A Fund whose governance structure does not respect these changes, as well as the need to give each member some voice and representation, will be an anachronism, without the legitimacy or the appearance of impartiality necessary to undertake the sometimes intrusive tasks entailed in facilitating international policy dialogue or international lending. This is why Fund governance has to change, giving more power to rising economies.

The International Monetary and Finance Committee, composed of the governors of the Fund, in the recently concluded Spring Meetings endorsed the Managing Director’s Medium-Term Strategy, which emphasises the need for change in all these areas. What I want to do today is outline some of my thoughts on the issues with a long-term perspective in mind. I should emphasise that what follows are my views only and not necessarily those of the Fund’s management or Board .

[1] Economic Counsellor, IMF. I thank David Robinson for useful conversations, Graham Hacche, Laura Kodres, and Jonathan Ostry for useful comments.

Multilateral action

Perhaps the best place to see the Fund's possible role in encouraging multilateral action is in the growing global current account imbalances. The United States is running a current account deficit of 6.5 percent of GDP - meaning it spends far more than it saves - in the process absorbing nearly 70 percent of world external savings. Any industrial country running such a large deficit becomes reliant on the mood of foreign investors not so much because foreign investors will inflict a "sudden stop" but because they are likely, at some point, to start demanding a much higher premium for continuing to finance.

A useful way to think about the build-up of global current account imbalances is to see them as developing in three stages. In the first stage in the late 1990s, a variety of crises in the emerging markets and Japan reduced investment opportunities there, freeing up savings, while strong productivity growth made the United States an attractive place to invest . It is quite reasonable, even if somewhat imprecise, to say that at this stage the US capital account surplus was driving its current account deficit.

In the second stage in the early 2000s, the bursting of the information technology bubble was met with very accommodative policies in developed countries, particularly the United States. Consumption increased to offset the fall in investment, especially in countries with strong mortgage markets, where rising house prices and the associated wealth effects were a strong support. The accommodative policies were not reckless - they offset what would otherwise have been a collapse in global demand and growth.

In the third stage, strong growth the world over, but especially in countries with commodity-intensive demand like China and the United States, came up against the limited past investment that had taken place in that sector. The oil and commodity price shock has widened but also shifted the current account imbalances.

Under this reading of the development of imbalances, at least three points are worth noting: First, the imbalances were a consequence of a series of different shocks and associated policy responses, all of which tended to aggravate the US current account deficit. Globalisation has indeed permitted shocks to the world economy to be spread more widely, and the resultant imbalances financed, without serious consequence to world growth. Policies were appropriate for the times, and these include the Chinese decision to maintain the peg against the dollar during the Asian currency crisis, which helped avert further destabilising devaluations in Asia.

Second, however, this does not mean that a continuation of past policies that were appropriate when initiated is now desirable. Also, one must not neglect the role of policies that were not undertaken in producing the situation we are in today. For example, if structural reforms had produced high productivity growth in the euro area in the late 1990s, perhaps the euro area might have attracted a significant share of the capital inflows that went to the United States. Or if emerging Asia outside of China had improved its business climate substantially after the Asian crisis, perhaps investment would have rebounded quickly and the countries would have run lower surpluses. Or if the US had stronger policies encouraging energy conservation, perhaps its deficit would not have expanded as much with the rise in energy prices.

Third, it is hard to say when, where, and how future shocks will hit. The ability to run current account imbalances allows the world to buffer shocks and spread them widely. This is a good thing. It is important, therefore, that we bring down imbalances in stable times so that we have room to expand them when future shocks hit. This is just prudent counter-cyclic global policy.

In sum, the imbalances are unsustainable at their current level; even with increasing economic integration, there is a limit to how much a country can depend on the outside world. Deficit countries have to start thinking about weaning themselves off reliance on global savings while surplus countries have to find ways to depend less on external demand. Since adjustment is inevitable, would it not be better to commit to a medium-term policy framework today so that public policy can support the needed private sector adjustment and ensure the process is smooth?

A set of such frameworks for all the major players would have two additional effects. First, it would indicate that the imbalances are a shared responsibility and help prevent concerns about imbalances degenerating into protectionism, or into calls for one country alone to narrow its deficits or another to appreciate its exchange rate, measures that will be ineffective by themselves. Second, it would reassure financial markets that a policy framework for supporting adjustment is in place, thus limiting the risk of an abrupt and costly market-induced adjustment.

What prevents countries from offering such frameworks without the coaxing of the outside world?

A change of domestic policy, especially if current policies are doing no visible damage, is undoubtedly politically costly because it risks alienating constituencies that have grown to support current policies. Similarly, a variety of structural reforms inflict current pain in return for future gain (World Economic Outlook 2004). It does not take genius to recognise that the personal calculus for the short-sighted politician militates against undertaking policies that have such a pattern of payoffs. But are there not far-sighted politicians? Isn't the benefit from global risk reduction worth the costs that will anyway eventually have to be paid since the policies the Fund recommends - lowering deficits, structural reforms, allowing exchange rates to appreciate - are in countries' long-term interest?

Unfortunately, even if the politicians in a country are far-sighted, only domestic benefits will enter their calculus: the effects of their actions on reducing risks for everyone else is heavily discounted. As a result, policies that have large external spillover effects may not be undertaken. This means some way has to be found to persuade countries to internalise the beneficial effects their policies will have on everyone else - to internalise the spillover effects.

Another possibility is that country policies may have much greater effect when they are exerted in concert and little effect when exerted separately. In the jargon, policies may be strategic complements. For example, current accounts may shift dramatically in the desired direction if deficit countries contract demand and surplus countries allow their exchange rate to appreciate, while they may not change much if only one side undertakes actions. In such situations, a multilateral commitment to undertake policies may be the only way to get policy action.[2] So is the movement on policy actions to narrow global imbalances limited because:

1. Politicians don't think the risks of an abrupt adjustment are high or that the recommended policies will do anything to narrow imbalance; or
2. They think the risks are high but they care more about the high cost to their own political futures if they undertake corrective policies; or
3. They think the risks are high, and they want to do what is right for the country, but the domestic cost of action outweighs the domestic benefit because much of the benefit redounds to the rest of the world; or
4. They think the risks are high but they cannot move unless others move?

My sense is that some element of all four of these are playing a role in limiting policy movement thus far. The IMF can help here. Through its analysis of a country's situation, the Fund can point out (and has pointed out) when the benefits of action are high and exceed the

[2] It may also be that the political room for one country to undertake difficult policies may increase if it can show that other countries are also experiencing some painful adjustment for the global good.

costs. Because the Fund does not have a vested interest in the country's political debates, it can show where the high road lies, and urge the country's authorities to take it. In the first two cases above, multilateral dialogue can help only to the extent that peer pressure (or peer support) is useful. Given that countries are often diplomatic in multilateral settings, the Fund could play a role through impartial and careful analysis and by being brutally honest on who is not playing their part. And when there are international spillover effects, the Fund can bring countries together to consider joint action. Even if there is no way for a country to internalise the risk-reducing effects its actions will have on a second country, it may be persuaded to undertake the actions if it knows that the second country will also undertake actions that have positive spillovers for the first country. Finally, when there are significant complementarities so that coordinated action is required, the Fund can help identify these and help broker an agreement.

But we must also recognise that the Fund can only take members to water but cannot make them drink. If they are not persuaded by the power of analysis or the possibility of joint action, the only resort the Fund has is to appeal to the collective persuasive power of its members. It is important therefore that the membership be fully supportive of the Fund's endeavours.

IMF lending

As global financing conditions become less benign, it will also be important to examine whether the Fund has the right lending instruments. The issue becomes all the more important because a number of emerging markets now have strong policies even though underlying structural vulnerabilities still exist.

One of the concerns expressed by our membership has been about the degree to which Fund support will be available in a time of crisis. At present, if a country looks like it is getting into trouble with financial markets and calls on the Fund, the Fund evaluates its needs, negotiates the conditions it will require to ensure the country can regain access to financial markets, and if a "programme" is agreed to, initiates lending. Before such negotiations are concluded, though, there is some uncertainty about the quantity of Fund lending a country will have access to and the conditions that will be imposed. The negotiation of a programme also takes time, although the Fund has speeded up the process in the past when needed.

Thus members and financial markets would probably like as much clarity about Fund intentions as possible a priori, so that Fund support can reassure markets rather than be a source of uncertainty.

A second concern emerging market members have is about the degree of conditionality that will be involved in order to get support. A little background is probably useful here. Simplifying somewhat, the Fund requires members who want loans to undertake actions that will ensure they get back on their feet, and this forms the basis of Fund conditionality. Conditions could be about policies (eg, the size of the fiscal deficit) or about the structure of the economy (eg, the size and extent of tariffs, the extent of state ownership, etc). Structural conditionality increased tremendously in the early 1980s as the Fund's lending shifted from industrial countries to emerging markets, who had more structural constraints and vulnerabilities.

This last move, though motivated by the need to foster growth, has not been universally welcomed. Even though the Fund has taken significant steps to streamline conditionality, we are still reminded by Asians of the 140 or so conditions imposed on Indonesia in 1998. Our emerging market members do indeed fear that if they ever get into trouble again, they will be open to all manner of intrusive conditions if they approach the Fund for a loan, including possibly those motivated by the ideology of powerful members or their need to secure a political or competitive advantage. While I believe these fears are excessive, one cannot deny they exist. In fact, in order to maintain their “independence” from the Fund, a number of emerging markets have built large pools of reserves, in the process intervening heavily in exchange markets.

If the Fund is to persuade these member countries to reduce their costly self-insurance and the distortionary policies that accompany a large reserve build-up, it has to offer lending that recognises the greater maturity and continuity of policies and reforms in some of these countries. A greater focus on identifying which countries have mature policies (what the private sector calls screening, or what in Fund parlance could be termed “ex ante” conditionality) could reduce the need for programme conditionality, especially structural conditionality (what the private sector calls loan covenants or the Fund calls “ex post” conditionality). This will enable the Fund to move towards more of a system of insurance for some countries, where it largely pre-commits to help them up to a certain pre-specified amount when they have the need, with only light, largely policy-related conditionality, thus reducing the need for these countries to build up their own separate reserves.

What are the benefits of Fund insurance based on ex ante assessments of the quality of a country’s policies? It sends a clear signal to financial markets about the extent of Fund support that would be available. In this sense it reduces uncertainty and thus provides true insurance to a country - the Fund helps prevent crises rather than coming in after the fact, following a period where the market second-guesses the amount of Fund support available, when runs on the country have already started. Also, the clear signal of a country’s policies provided by the assessment, and the fear of loss of insurance if the country deviates from good policies, gives countries an incentive to stay on the straight and narrow, thus reducing potential moral hazard. Finally, the public nature of such assessments gives the Fund more of an incentive to sharpen them (rather than mask concerns in reports through language that is clear only to Fund officials), and for the Fund’s Board to play an active role in the routine assessment of policies since those assessments will mean a meaningful commitment to provide funds.

These benefits have to be traded off against concerns. First and foremost, important players may dislike such a system - countries because they are being assessed even outside a Fund programme (although the genuinely committed may favour such a system of reducing uncertainty), and large member countries because it reduces their (ex post) discretion over determining Fund lending.

Yet the reason for the dislike is precisely because the system might deliver what the Fund is supposed to do. Country assessments are supposed to be precise and candid (“ruthless truth-telling” or “brutally honest” in the words of some central bankers[3]), especially in a world where the Fund is an aid to international capital markets rather than a substitute. Large member countries do seem to want to bind their own future selves - witness the attempt to limit the quantity of exceptional access a Fund borrower will have through rules.

Is “insurance”, largely based on ex ante assessments, overly difficult to operate? Commercial banks do it all the time when they extend irrevocable lines of credit to corporations. Of course, banks typically also include a material adverse change clause which is invoked on the rare occasion when the client does something extraordinary to vitiate its own creditworthiness. The Fund could similarly reduce its exposure to a totally unanticipated change in a country’s policies by reserving the right to curtail previously determined insurance if a supermajority of the Board approves. Of course, this right should be invoked only in the rarest of rare cases.

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[3] See recent speeches by Governor King and Governor Dodge.

Will the Fund be held responsible for precipitating crises if it “downgrades” a country’s access? Not if it is doing its job and sending signals about policies going off-track well before a crisis. Of course, the risks here depend on the extent to which access is linked to ex ante assessments. In the Contingent Credit Line, an earlier attempt by the Fund to provide some sort of insurance based largely on ex ante assessments, countries were assessed on whether they qualified for such a line - a discrete “in” or “out” assessment. This raised concerns about an “entry” problem - would a country alarm markets if it applied for such a line - and an “exit” problem - would the Fund alarm markets if it decided a country’s policies no longer qualified it for access to the line? The way around the problem would be to make qualification and assessments more routine and the degree of access more gradated (that is, countries qualify for varying degrees of insurance). In this way, “entry” would not be news nor would “exit” be a sudden event. Of course, more gradated assessments and access raise a whole new set of issues that I do not have the space to go into here.

The point I want to make here is that the Fund is indeed engaged in finding new and better ways of crisis prevention, all of which will help us serve the needs of our membership better.

Governance

Another way to reassure emerging markets and developing countries that their interests will not be overridden is to give them more of a say in the governance of the Fund. This will ensure that the Fund has continued legitimacy, especially important if the Fund is to be perceived as impartial, bring countries together for dialogue, and step up its assessment of country policies. Clearly greater votes for countries that are underrepresented given their economic power is a necessary first step. A transparent process for choosing Fund management is also important, as suggested by the Managing Director’s strategy paper.

But in the fullness of time, we should also consider another anomaly, and that is that a country’s voting power, access to finance, and contribution to Fund resources are all determined by the same number - its quota. In practice, the Fund finds ways to get away from the tyranny of the quota (exceptional access in lending being one example), but in the long run we need to find a more flexible system.

For instance, emerging market countries that have excess reserves may want to pool them with others for use when a country gets into trouble. They may want to use the Fund to assess each other’s macroeconomic performance and need for resources, but may want more say over the kind of conditionality that will be applied than the Fund’s governance structure will ever allow . In short, they may want to finance a separate pool that relies on some of the organisational expertise of the Fund but allows the countries themselves a greater say in governance of the pool and greater flexibility in its design. The Fund has to recognise these needs and work towards a system that makes best use of the international expertise it has built up. The alternative is to see countries move away to setting up their own small arrangements independent of the Fund, which will waste the Fund’s expertise, limit the Fund’s ability to enhance the quality of multilateral dialogue, and forego the diversification benefits that would materialise if the Fund created worldwide pools.

Conclusion

Let me conclude. A little over 60 years after Bretton Woods, it is legitimate to ask whether the Fund indeed has a role. I have no doubt that it has, but the role is not the same as the one that was envisaged at the time of its founding. The times have changed. So has the Fund, and more change will be needed. The Fund is not perfect, and we have a host of critics -

well-meaning and otherwise - to remind us of that. The Fund can provide a better forum for multilateral dialogue as well as provide better services to its members. Our members can also make the Fund's governance more reflective of the changed world economic situation, which will enhance its legitimacy. All these are indeed key elements of our medium-term strategy, and I hope that I have given you enough food for thought so that you too can participate in the immensely important debate over how to change one of our most important multilateral institutions. Thank you.

Comments at the policy panel

20 June 2006

Usha Thorat

Mr. Malcolm Knight, ladies and gentlemen,

It is indeed very kind of you to have invited me to participate in this panel. The last two days have been a feast of research on the important issue of financial globalisation.

India has had steady growth of over 6 per cent since the 1980s and, more recently, the rate of growth has risen to 8 per cent. Its inflation rate has been reduced to less than 5 per cent and inflationary expectations have fallen. Reasonable growth with low inflation is regarded as the most powerful anti-poverty policy, an overall poverty reduction during the last 15 years has also been significant, although there are increasing regional differences. Meanwhile, large capital flows in excess of the current account deficits have led to a build-up of reserves, to $160 billion. Several policy measures, including a more flexible exchange-rate policy, expanded use of monetary policy instruments targeting short- term rates and liquidity conditions, efforts towards fiscal consolidation, strengthening of the financial system and adoption of global standards, calibrated opening of the capital account with preference given to FDI, FII and, to a much lesser extent, external debt – especially short-term debt – have helped minimise vulnerability as the country becomes increasingly integrated with global markets.

I do not want to get into details, as these are in many ways quite similar to the measures that Chile has adopted, as explained by the Governor. I thought I would go over each of the sessions in this conference and try to describe the more important policy implications that I am taking away from each of them.

The first session was on **democracy and globalisation**; and concluded that there is a strong correlation and perhaps two way causality between the two. I would like to suggest that perhaps there is an important third factor, technology, that has helped both processes: the rise of democratic forces as people everywhere have a window on the world through the media, especially TV and the Internet. The enormous increase in the efficiency of transport and communication, as well as information technology, in handling, processing and transferring huge amounts of information and funds (and securities) so critical to the development and globalisation of financial markets, has been a major factor.

India has been a democracy for 66 years, but it started integrating with the world economy only in 1991. How can this exception, like the Chinese exception, be explained? It was the external payment crisis of 1991 that compelled integration, but it was also the fall of the Soviet regime and loss of confidence in the role of the State that led to the dismantling of several controls and barriers. Trade integration and the opening up of equity flows, together with a flexible exchange-rate policy, has definitely led to higher growth and lower inflation.

The second session was on **globalisation and asset prices**. The point that ‘industry’ forces rather than ‘country’ forces dominate was interesting, as was the concept that contagion represents not a ‘common shock’, but the response of one market to idiosyncratic shocks in another. Higher foreign ownership of stocks and the behaviour of some foreign institutional investors can lead to more contagion because of distance and lack of information on the fundamentals. As Professor Calvo said, what is important is the outcome of contagion and how one deals with it. The answer again boils down to providing greater headroom and cushioning, including reserves accumulation, especially in the absence of any international financial architecture for support. This applies especially to countries having sound policies but facing contagion. The role of the IMF in this context will no doubt be elaborated by Raghu.

The third session, on **sudden stops**, was a very interesting one. I am more than ever convinced that the policies India followed to build cushions in the financial sector, such as headroom for increasing external debt when required, and managing huge inflows through the build-up of reserves and sterilisation so that the liquidity – both foreign currency and local currency – can be released when required without disrupting markets, have given us the ability and strength to manage sudden stops.

The fourth session, on **the role of foreign banks in the financial sector**, highlighted the role of foreign banks in enhancing efficiency and competition as they bring expertise in forex and debt markets, risk management and economies of scale, and especially technology to the host countries. However, increasing consolidation and the rise of huge international financial conglomerates do pose challenges as to how stakeholders' interests will be handled during periods of crisis, especially when these entities are largely shareholder value-focused. The loss of information, the need for greater transparency, especially for ensuring market discipline through listing, and the need for focus by regulators on issues of governance, specifically the role of independent directors and information flows to the CEO and supervisors, are some of the policy issues that emerged from this session.

The fifth session, on **home bias,** highlighted the need for improving standards of governance for countries and companies, especially the latter. Lower insider holding leads to lower home bias. For better governance, there is a need to encourage diversified holding, recognising at the same time the efficiency argument for more concentration and thereby effectiveness of control. The complexity of ownership and control in global companies, especially large, complex financial institutions, needs to be recognised. Enforcing a fair take-over code, especially for minority shareholders, is an important lesson, as home bias is minimised when these conditions are prevalent.

The last session, on **global imbalances,** was perhaps the most provocative. Can the current imbalances, described as an 'equilibrium' state, persist indefinitely? What needs to be done, especially by those who have contributed to the imbalances, has been clearly articulated. But these steps will take time and indeed it is important that the unwinding is orderly. India has not contributed to the imbalances; our savings and investment are largely in balance, we have a small current account deficit, and reserve cover is substantial. However, if it is the case that the imbalances cannot persist indefinitely, disorderly unwinding would affect both growth and price stability, as we see interest rates and inflationary expectations rising, oil prices remain high and the pass-through begins to take effect. In India, some of the oil price shock has been cushioned by the Treasury; interest rates have been increased on three occasions. Countercyclical prudential measures have been adopted to minimise financial system vulnerability; these include building up an investment fluctuation reserve as yields dropped to cushion a future fall in bond prices (especially as government bonds are a significant part of bank assets), higher risk weights for exposures to real estate and large housing loans, higher provisioning for some standard assets, and a move towards increased monitoring of exposures to companies with large, unhedged exchange-rate exposures.

Global developments are becoming increasingly important in the conduct of monetary policy in the context of greater trade and financial globalisation. For this reason, sovereign governments, central banks and regulators need to focus on international cooperation to ensure global financial stability.

Financial globalisation and financial stability

Zdeněk Tůma

1. Concepts and interpretations

Financial globalisation is just one dimension of the complex process of globalisation. Without doubt, this process has changed the economic landscape worldwide in recent decades, and not only the economic landscape.

The main changes brought by financial globalisation are trends towards intensive cross-border financial and payment flows, greater risk-sharing internationally through a broader array of financial instruments, an increasing share of cross-border holdings of assets and an increasing international profile of financial markets, market players and institutions.[1]

These developments in the global financial system are, to some extent, a revival of the characteristics of the gold standard. In this sense, we are currently witnessing a "second wave" of financial globalisation.

1.1. Driving forces

When discussing the driving forces of globalisation, and of financial globalisation in particular, observers mostly highlight the impact of technological advances in the elaboration and transmission of information, the quickening pace of financial innovation and the decreasing cost of communication. These changes have materialised in parallel with a wave of financial liberalisation both within and across national borders. In my view, the combination and interaction of these technological factors with sweeping liberalisation and deregulation is evidently the main driving force of financial globalisation in the contemporary world economy.

1.2. Impact of financial globalisation

Under the impact of financial globalisation, a gradual shift from the government-dominated system of the Bretton Woods tradition to a market-led system has evolved. Exchange rates, liquidity conditions and adjustment to shocks are increasingly determined by decentralised market forces.

In the changed environment, a gradual shift from bank-centred to market-based financing is taking place, albeit at a different pace in individual countries and regions. The resulting decline in banks' core business areas has forced them to search for other opportunities both at home and abroad.

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1 Indicators approximating the degree of financial globalisation include the share of cross-border holdings of assets, the sum of external assets relative to GDP, and the degree of co-movements of market indices, bond spreads and stock market indices.

1.3. Gains from globalisation

Financial globalisation has brought indisputable gains - sources of financing are cheaper, wider and more flexible and risk taking is rewarded. There are also arguments that this financial opening has had growth effects. Although plausible, they are as yet only weakly supported by empirical work.

The distribution of the gains from financial globalisation, both across and within individual economies, is not straightforward. Less developed countries, for example, are expected to benefit more from wider access to the credit and securities markets of the developed nations. However, after a series of financial crises, especially in the 1990s, the sceptics have claimed that the costs of financial opening in emerging markets are likely to outweigh its uncertain benefits.

However beneficial the globalisation trends may be in terms of economic efficiency, the implied changes, increased cross-border competition and pressure to adjust have provoked resistance and calls for protection, and not only in emerging markets. Throughout the world economy we can observe an increasing aversion to risk and to change.

1.4. There are no free lunches: the costs and risks of financial globalisation to financial stability

In the post-war conditions of financial repression, the controls applied kept financial instability in check. By contrast, globalisation and liberalisation have been accompanied by frequent episodes of imbalances and financial instability in both developed and emerging markets.

Let me recall some of them: the banking crises in the Nordic countries and Japan in the late 1980s, the Mexican crisis of 1994, the Asian crisis - with severe banking problems - encountered in 1997 and 1998, and the Russian default of 1998. There have also been a number of high-profile institutional failures, among them that of Long Term Capital Management.

The Mexican and Asian crises, in particular, were of a systemic nature, reminding us that financial markets have a growing capacity to transmit shocks, both across borders and across markets.

The list of financial shocks in recent decades also includes the global stock market crash of 1987, the bursting of real estate bubbles in the late 1980s, and credit and asset price booms and busts. Experience has shown that in a number of instances the bust phase of the cycle has been accompanied by a crisis in the financial system.

In many emerging market economies, domestic tendencies towards credit, asset price and investment booms have been reinforced by capital flows. Their abrupt reversals have deepened the bust phase. Moreover, emerging market economies - unlike developed ones - as a rule have not been able to borrow in their own currency. The resulting costs to the real economy have thus been greatest when, due to currency mismatch problems, banking crises and foreign exchange crises have coincided.

1.5. Interpretation of financial woes

The above evidence suggests that the global financial system has been subject to a growing number and increased variety of financial woes over the last few decades. The explanation of their roots and relevance may, however, differ.

Some observers tend to consider these woes as only transitional problems. They claim that learning to live with a more liberalised financial sector and modern financial technology is bound to take time.

The other approach underlines the structural character of the changes in both the financial structure and financial behaviour. The liberalisation of the global financial system has sharply increased the competitive pressure in the financial services industry and, in turn, the incentives to engage in risky behaviour. Interactions between the changed financial structure and the changed behaviour allow financial imbalances to build up.

Let me make a clarifying note here. From the analytical and policy points of view, the build-up of financial imbalances should be distinguished from outright financial instability. These phenomena differ in their horizons as well as in the trade-offs involved.

Financial instability implies that due to some shock the financial markets are not properly performing their standard functions, ie, effective mediation between creditors and debtors, spreading of risks and efficient allocation of resources to particular activities and over time. Such a situation, with its serious implications for payment and other systems, can be quite disruptive to economic activity.

Financial imbalances, on the other hand, represent trends in the balance sheets and/or the pricing of assets that are considered undesirable, either because they depart from fundamentals or because they expose the economy to the risks of a reversal. Of course, financial imbalances may develop into outright financial instability. When financial imbalances grow too far and/or for too long, they do have the potential to trigger financial instability, especially if financial institutions' balance sheets are exposed to such risks.

2. Policy responses: how to preserve financial stability in the changed economic landscape?

Financial globalisation has brought obvious gains in terms of economic and financial efficiency. The other side of the coin are its costs and risks, in particular to financial stability, as illustrated above. In what follows, I will focus on this particular issue. More precisely, I will focus on assessing the approaches to preserving financial stability and reducing its vulnerability in conditions of financial globalisation.

The main avenues for coping with the impact of financial globalisation on financial stability which have developed in recent decades are:

- the departure from the pegged exchange rate regime of the Bretton Woods tradition and the shift to flexible exchange rates;
- the implementation of an extensive system of prudential regulation and supervision;
- the proper sequencing of liberalisation and institution-building, an issue of particular importance to emerging market economies.

Each of these approaches has its merits, but also its limits. Their contribution to the preservation of financial stability has proved to be only partial in reality and, consequently, the search for further solutions inevitably goes on.

In this respect, two strands of reasoning appear to open up for discussion:

- Are the regional integration projects, of which the European Monetary Union (EMU) is the most advanced example, a means of preserving financial stability in the era of financial globalisation?
- Should monetary policy also address financial stability?

Let me briefly tackle these options in turn.

2.1. Shift to flexible exchange rates

The trends towards an open capital account have underscored the issue of the "impossible trinity", ie, the co-existence of monetary policy autonomy, a fixed exchange rate (hard peg) and an open capital account.

As monetary policy has continued to focus on domestic goals (its dominant orientation on employment in the 1950s and 1960s has shifted to price stability since the 1970s), a solution to the "impossible trinity" has been sought in a move away from pegged exchange rates and towards flexible ones.

As a result, the combination of pegged rates and an open capital account is rare in the contemporary world economy as a long-term solution. Flexible rates dominate, especially among the major countries and currency areas. This flexibility, though, is not a corner solution as a rule, being restricted through occasional intervention.

True, a number of stabilisation programmes have anchored monetary policy using a hard peg for the purpose of disinflation, but mostly only temporarily. Experience has shown that adhering to a hard peg for too long is likely to be punished with a foreign exchange crisis. Such a delayed exit from a pegged rate was suffered in the Czech case and resulted in the currency turbulence of 1997.

2.2. Sequencing of liberalisation and institution-building

Although the advanced countries have also gone through episodes of boom and bust in credit and asset prices, experience has shown that the probability of a full-blown financial crisis is higher in emerging market economies. The latter are constrained by their institutional and structural weaknesses. Unlike developed countries, they cannot borrow in their own currency. By their nature these economies are susceptible, in particular, to foreign exchange and currency crises, which are rare in advanced countries.

As these lessons have been learned, an approach stressing proper sequencing of liberalisation and institution-building has gained ground. To decrease the risk of vulnerability:

- Instead of sweeping liberalisation, the arguments call only for a gradual opening of the capital account, with liberalisation of long-term capital before short-term;
- Prior to liberalisation, sound macroeconomic policies and an effective supervisory and regulatory framework should be in place.

These principles are now widely accepted. It is sobering to note that their implementation is also advocated by the staff of international institutions, such as the International Monetary Fund and the Organisation for Economic Co-operation and Development .

2.3. Prudential regulation and supervision

In the changed economic landscape, financial instability could not be fought with ex post emergency lending only, as it could under the gold standard, nor did financial repression provide a check on its overt forms as it did under the Bretton Woods system. As a result, demand arose for the prudential apparatus to be elaborated, extended and widely enforced. In the course of time, this increasingly sophisticated apparatus has become the key element in the pursuit of financial stability.

Liberalised financial systems appear to be “inherently procyclical”, as Borio et al.[2] show. Perceptions of value and risk move up and down with the economy, as does the willingness to take risks. Credit spreads, asset prices, internal bank risk ratings and loan loss provisions all move procyclically. Related to this, the regulation applied has also proved to be procyclical in nature, exacerbating cyclical developments in individual economies. To correct for this, a more symmetric response to the expansionary and contractionary phases of the business cycle has been sought when devising prudential regulation instruments. Nevertheless, regulation can hardly change the procyclical nature of the financial industry.

Furthermore, experience has shown that financial crises are not due primarily to troubles in individual institutions or to contagion of such troubles from one institution to another. Common risks are a much more serious concern. As a result, the importance of a macroprudential regulatory framework has been increasingly underlined, putting more emphasis on the health of financial system as a whole, rather than the state of individual institutions, as was the case in the past.

2.4. Regional integration in the era of financial globalisation

Regional integration projects appear to be becoming increasingly attractive, and not only on the European continent. Nevertheless, the euro area is the most advanced one and its experience can provide an insight into the trends of financial globalisation under monetary union conditions . In this respect, I will focus on two issues: first, the euro area’s solution to the “impossible trinity”, and second, the impact of financial globalisation on European financial markets.

Launched with the start of the third stage of the EMU in 1999, the euro area represents a specific way of addressing the issue of the “impossible trinity”. A single common currency was introduced by irrevocably fixing the exchange rates of the member countries. The regime of the new currency unit - the euro - is, however, fully flexible.

The monetary policy autonomy of the individual member states has been subordinated to the supranational European Central Bank, which implements a common monetary policy. In the existing framework, the common monetary policy has no counterpart, as other macroeconomic policies are implemented on a national basis. It should, however, be underpinned by coordination in other policy fields, in particular in the fiscal area.

Under this arrangement, the open capital account of the entire monetary union and its individual member countries has been smoothly sustained.

Nevertheless, the general wisdom of economists suggests that the key determinant of the lasting success of a single currency area is a high degree of flexibility. The EMU has been built on compliance with a set of stability criteria, but it has repeatedly been found to lack the desirable degree of flexibility, in particular in the labour market area.[3]

Let me also mention that at present countries that want to join the euro area have to meet targets for macroeconomic stability (the Maastricht criteria), but are not explicitly required to improve their flexibility.

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2 Borio, Furfine and Lowe (2001), ”Procyclicality of the financial system and financial stability: Issues and policy options”, BIS Papers No.1.

3 A recent research paper has argued that the pace of structural reform slowed down after the launch of the euro area. See Duval and Elmeskov (2005), “The effects of EMU on structural reforms in labour and product markets”, ECB conference, Frankfurt, 16-17 June 2005.

Financial globalisation and European financial markets

The EMU was built on a high degree of real and financial integration within the EU in previous stages. In turn, the EMU was expected to boost the integration of European financial markets and to foster trends of financial globalisation.

Although prudential supervision, regulation, system oversight and crisis management have been primarily designed to manage systemic risk at the national level and only partly take account of cross-border systemic risk, the single market and follow-up legislation have encouraged deregulation of banking and other financial services and removed barriers between the banking, insurance and stock markets. On top of that, by eliminating or at least lowering the obstacles to cross-border transactions, the introduction of the euro has boosted the deepening of financial markets.

However, these gains have been uneven across the range of financial markets. The money market (with the exception of the short-term securities market) was integrated right at the start of the monetary union, the integration of the government and corporate bond markets has progressed considerably, while the euro area equity markets are still quite fragmented. In the banking area, there is a considerable difference between interbank (wholesale) activities and retail banking. While cross-border interbank loans have experienced substantial growth, integration in retail banking has been rather limited so far. Retail operations have traditionally been subject to a relatively high degree of regulation and government intervention. This may explain why segmentation has remained most visible and pronounced in that particular field and why the expected wave of cross-border banking integration and consolidation has failed to materialise, at least until recently.

European banks have grown substantially since the launch of the euro, although until recently not in the way that had been expected. Despite the single market legislation, the single licence and deregulation, the consolidation has materialised mostly within national borders. Only recently have there been signs that big cross-border bank mergers have become more attractive and are being strived for. This may suggest that the consolidation in domestic markets has reached its natural limits. The other reason may lie in changing political will and in a less protectionist attitude to cross-border acquisitions; in other words, they may be getting easier to implement.

Despite uneven progress, with the benefit of hindsight we can conclude that the introduction of the euro, together with accompanying systems such as the TARGET funds transfer system, represents a step change in financial market integration and in the transmission of financial globalisation.

Unlike the “old” EU member states (the EU-15), in the “new” member countries (the EU-10) the share of foreign institutions in the operations of local financial markets and in banking business is high. In the Czech Republic, for example, more than 95% of the banking sector’s assets are in foreign hands. The explanation lies in the coincidence of interests of foreign investors and locals. Growth opportunities, higher margins and strategic aims appear to be major incentives for foreign investors to enter these markets. On the other hand, the entry of foreign banks was expected to stabilise the domestic banking sector and resolve the pressing problem of a high share of non-performing loans. Moreover, the operations of foreign banks were expected to bring substantial benefits to economies in transition: a strengthened competitive environment, transfer of know-how, improved services and increased efficiency of domestic financial markets and banking institutions.

Nevertheless, this situation may involve some risks, in particular in the implied asymmetry between the role of local operations for the foreign bank and for the host country economy and markets. As a rule, the operations of foreign banks in host countries have only marginal importance in terms of the volume of such banks’ activities, but considerable weight for the host country. This asymmetry may represent a concern for the authorities of both parties involved - supervisory authorities, central banks and possibly governments as well. Their interests, procedures and preparedness for dealing with liquidity problems in a foreign bank’s operations in the host country, or possibly even a crisis, may be quite different. Consequently, the issues of common standards, cross-border coordination and cost- and risk-sharing should be dealt with.

2.5. Should monetary policy address financial imbalances and financial instability?

Monetary (price) stability and financial stability are in principle mutually reinforcing. Data show that central banks and their monetary policies have been quite successful in keeping inflation in check in recent decades. A low-inflation environment has been sustained in most national economies, including transition economies and emerging markets. However, the frequent occurrence of financial imbalances, asset and house price bubbles and overt financial, banking and currency crises has proved that low inflation does not guarantee financial stability. In fact, several financial crises and asset price bubbles have developed in an environment of low and stable inflation.

The ongoing debate on what role financial imbalances and asset prices should play in monetary policymaking can be classified into two opposing approaches. According to the first one, central banks should take into account information from asset price movements and financial imbalances if and insofar as they have an impact on the inflation figures and the goals of monetary policy. This seems to be subject to little disagreement.

The other approach suggests that central banks should respond to imbalances as they build up, even when the (short-term) outlook for inflation and growth does not seem to be affected and remains favourable. The argument is that growing imbalances will have adverse consequences if left unchecked. This will become true if and when these imbalances develop too far and prove to be out of line with fundamentals. The unwinding of such imbalances can be rather costly to the real economy.

In the discussion, this view is termed pre-emptive or proactive monetary policy. Under this approach, monetary policy should be used not only to cushion the consequences of financial imbalances, but to act pre-emptively and decrease ex ante the probability of such imbalances having a negative impact. It is presumed not only that boom-bust cycles are linked to financial imbalances, but also that their magnitude and spread can be influenced by policy. The proactive view is thus a sign of discontent with the reflection of financial imbalances in the "standard" monetary policy and its underlying models.

The disagreement relates to the aspirations of pre-emptive moves. As far as I can judge, the majority view seems to be that central banks should not respond to such factors, except, perhaps, in extreme situations where financial stability is evidently threatened. In that respect, compelling arguments have been made during the discussion: difficulties in timely identification of evolving financial imbalances, in view of time lags in the transmission of monetary policy; and calibration issues - interest rate changes are too "coarse" an instrument for the purpose, as they may be either quite useless or, in the opposite case, trigger the situation which they were intended to prevent.

Nevertheless, the interaction between monetary policy and financial stability is likely to represent an "ongoing concern". In the Czech Republic, we operate with an inflation targeting regime, so the discussion within that context is of particular interest.

In general, it seems entirely plausible to reflect factors which are not directly incorporated into the applied policy framework and its underlying model, including financial imbalances, judgmental adjustments and inflation and output forecasts. The potential shortcomings of inflation targeting in handling financial imbalances may materialise when interest rates are set to bring inflation forecasts to the target over some fixed horizon and this horizon appears to be too short. Proposals for modification of inflation targeting to better incorporate the risks posed by financial imbalances therefore often suggest lengthening the policy horizon. The concept of "flexible inflation targeting" underscores this issue: there is a commitment to a long-run numerical target for inflation, consistent with the price stability goals of the central bank, but with no fixed time frame for attaining it.

Of course, the above considerations are of relevance to monetary policy transparency and accountability, monetary policy communication strategy and public understanding of the policy formation process.

In conclusion:

The policies and approaches discussed, although reacting to the changed landscape of the contemporary world economy in different fields and through different instruments, have in common their efforts to:

- reap the gains from financial globalisation and avoid a retreat towards economic nationalism and protection, as was the case with the fall of the gold standard;
- minimise the risks and costs involved in financial globalisation both across and within countries and regions.

Needless to say, this is a never ending game.