François Villeroy de Galhau: Numerous challenges for the international monetary system

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the High Level Seminar on International Financial Architecture, Paris, 31 March 2016.

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Ladies and gentlemen,

France, and the Banque de France in particular, has a long tradition of spurring high level reflections on the international financial architecture, such that we very much welcome the creation of the IFA WG by the Chinese presidency. This new working group echoes the IMS (International monetary System) Working Group that was launched under the French presidency of the G20 in 2011. At the time, the debates on the IMS were already very intense, as witnessed for instance by the profusion of proposals to amend the IMS, such as the Palais Royal Initiative, led by one of my predecessors as Governor of the Banque de France, Michel Camdessus. Before that, we all remember the work done by another former Governor of the Banque de France, Jacques de Larosière, who contributed a very influential report in 2009 on the European Union, which also had an international dimension. The Eurosystem, on its part, is committed to financial stability. We decided on March 10th a comprehensive and powerful package, aiming to provide favorable financial conditions for the economy. We will look closely at these financial conditions in the future and if needed, we could act further.

The international monetary system is still facing numerous challenges. I would like to offer a few thoughts to launch our discussion today. I will start with the risks and vulnerabilities caused by excessive volatility and procyclicality of capital flows; I will then turn to the policy responses, including means to address the volatility of capital flows directly and issues related to the GFSN (or Global Financial Safety Net).

I. Regarding ***international capital flows***, it is fair to acknowledge that we do not have a good benchmark on what would constitute an appropriate level of these flows. There is a trade-off between the costs and the benefits that they bring, and this trade-off varies across countries and over time. Yet, the fluctuations in gross global capital flows do seem to be very procyclical and volatile. If we look at gross inflows in advanced economies for instance, we see that they rose considerably in the years preceding the Global Financial Crisis, from less than 10% in the early 2000s to more than 20% in 2007. Subsequently, they plunged to virtually 0% in 2008 and 2009 and have remained low ever since. Not all types of flows show the same dynamics over time: FDI and portfolio equity flows have been fairly resilient, while bank flows and debt portfolio flows have been very significantly affected, resulting in a marked changed in the composition of gross flows.

These sharp fluctuations are clearly not optimal. Even bearing in mind the caveat that I have outlined earlier on the lack of a clear benchmark, it looks like international capital flows are too abundant in good times, potentially fueling domestic bubbles and destabilizing national financial systems, and prone to “sudden stops” in bad times. Emerging market economies have experienced numerous examples of “surge” episodes of capital inflows followed by perilous sudden stops. Current (and preliminary) data suggest that some EMEs are currently experiencing very large outflows. The potentially destabilizing effects of capital flows may be magnified in the current situation, with disappointingly slow economic growth (of a cyclical and structural nature), high volatility in commodity and asset prices, the persistence of both internal and external imbalances in key countries and regions, substantial amounts of currency mismatch on balance sheets in emerging market economies, etc.

II. ***So what should be done?*** I think that we should try to be both pragmatic and ambitious. If we are not pragmatic we will waste time exploring paths that will not lead us anywhere, but if we lack ambition we will never make progress.

We should, first, develop a framework to ***prevent*** excessive capital flow volatility. Here I see three main avenues to explore:

(i) improving the ***monitoring*** of capital flows and hence taking forward the work on data gaps on foreign currency exposures and mismatches.

(ii) proactive ***macro-prudential regulation*** to prevent unsustainable debt and limit foreign currency borrowing can be useful to reduce the procyclicality of financial flows, avoid excessive risk-taking and ensure an orderly external sector adjustment.

(iii) Finally, one could also explore ***state contingent financing instruments***, such as GDP linked bonds, which could also offer innovative means to smooth external financing needs and avoid expanding scarce resources on assistance programs.

However, prevention can never cover all risks and so, ***we need a stronger GFSN***. As highlighted by the IMF the global financial safety net, although larger, has also become more fragmented and asymmetric. Some of its key building blocks have not been fully tested, and some of its key aspects suffer to various degrees from being costly, unreliable, and lacking adequate policy incentives.

This shared diagnosis offers a key opportunity to strengthen the GFSN. Reserves, swap lines and Regional Financial Arrangements (RFAs) are not a substitute for having a strong, well-resourced IMF at the heart of it, on the back of the recent approval of the 2010 Quota and Governance reforms, which has strengthened the Fund legitimacy. From our perspective, three elements stand out:

First, identify potential ways to improve the use of existing IMF facilities, notably precautionary facilities, and/or consider the possible creation of new facilities. The objective here is to mitigate stigma, without creating moral hazard.

Second, ensure that the IMF is adequately equipped to deal with the vulnerabilities of Low Income Countries, Emerging Market Economies and commodity exporters: GCC (Gulf Cooperation Countries), CEMAC (Central African Economic and Monetary Community) and Latin American countries have all been affected by the recent drop in commodity prices. Broad coverage requires making sure that the IMF is adequately resourced, both in terms of permanent resources, and through state contingent financing resources in case of common shocks or systemic crises.

Third, there are also ways for the GFSN to operate better without the Fund extending more financing. There may be benefits in further use of ***"signaling" instruments***, which share most of the features of regular programs but without financing. For example, countries like Sénégal or Nigeria have relied on the IMF Policy Support Instrument: this program enables low-income countries to benefit from Fund's advice and support, which sends a clear signal to donors, creditors and markets. However, these instruments are only available for low-income countries; there is to date no equivalent tool for emerging or advanced economies. Such instruments could help in certain situations (for instance during systemic crises) where it is essential to maintain market access and facilitate rollover of private financing.

With this I would like to conclude my presentation. I very much look forward to our discussions today and to seeing the work of the IFA work stream in the coming months.