Peter Praet: The future of global financial integration

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Global Research Forum on International Macroeconomics and Finance, Federal Reserve Bank of New York, New York City, 17 November 2016.

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I. Backlash against financial globalization since the global economic and financial crisis

Financial globalization was a salient phenomenon of the past three decades, but since the financial crisis of 2007–2009 there are increasing signs of a backlash against globalization.

The evidence for such a trend reversal is mixed.

Quantity-based measures of global financial integration, such as gross external assets relative to world output, have flattened out, and would merely point to a pause.

Flow measures provide a gloomier picture: international capital flows are now down to half their pre-crisis levels relative to world output, and are especially weak among mature economies.[1] Internationally active banks have increased domestic lending faster than foreign lending.[2] Several emerging markets have erected barriers to global finance and introduced controls against capital inflows and, more recently, outflows.

Price-based measures of global financial integration, meanwhile, present a different picture: international equity market co-movements, for example, remain strong. By some estimates, they remain as high as ever in more than a century.

It is not just the extent of financial globalization, which might have changed since the financial crisis, though. Its perceived benefits and costs in academic and policy debates have changed, too. Before the crisis several studies already called for a "reappraisal" of the net benefits of financial globalization.[3] This has taken place along two main dimensions: (i) re-assessing the stability of capital flows, and (ii) re-examining whether financial integration leads to a productive allocation of savings and to agglomeration effects in certain geographic areas.

As regards the first dimension, the notion that financial integration which is based on long-term instead of short-term capital flows is more resilient has become increasingly persuasive. For the second, it has been recognised that financial integration typically only delivers lasting positive effects on growth if countries meet certain thresholds of institutional development.[4] In the absence of sufficient institutional development, capital flows would most likely be used unproductively, feeding unsustainable lending booms and encouraging excessive short-term capital inflows.[5] This can in turn leave countries vulnerable to sudden stops once optimism fades due to local or global shocks.

Indeed financial cycles tend to have a global component, and hence the discussion about financial globalisation has evolved into one about the "global financial cycle", which is driven by US monetary policy. The assumption is that non-US central banks have lost their ability to influence domestic long-term interest rates, even in the presence of flexible exchange rates, due to the existence of "US-driven" global financial cycles.[6] As a result, the classic trilemma[7] may have morphed into a dilemma between financial openness and monetary policy autonomy. In addition to risks related to unsustainable lending booms, which can be fueled by capital flows, policy makers and academics recently also stressed risks stemming from disruptive capital outflows, which can endanger financial stability, for example if large amounts of bank deposits are pulled out of a country.

In the context of this debate on financial integration, academic papers on the welfare optimality of taxation of international capital flows have also thrived since the crisis.[8] Moreover, the standard international policy consensus on financial globalization has been shattered by the crisis. For example, the IMF adopted in 2012 an institutional view that said temporary and targeted capital flow management measures can be useful in certain circumstances, i.e. when the room for manoeuvre for macroeconomic adjustment is limited.[9] The Fund is now reviewing this institutional view. It is expected that the effectiveness of capital flow management measures, which have been recently used in emerging and some advanced economies, will be assessed in a balanced way, taking into account all intended and unintended effects, which such measures may generate.

In parallel, the OECD is reviewing its code of liberalization of capital movements. With the review, the OECD aims to facilitate collective action by boosting transparency and shared understandings on good practices related to managing and liberalising capital flows. A particular area of interest is the treatment of capital flow measures that are used as macro-prudential measures. For policy makers, this is important since at times there may be tradeoffs between financial integration and financial stability.

II. Effective financial risk sharing rests on the soundness of institutions and policy rules

As part of this policy discussion, I would like to underline that openness to international capital flows should continue to help diversify country-specific shocks. This would help to smooth cross-border consumption between good and bad states of the world through international borrowing and lending. Admittedly, the economic magnitude of gains from financial risk sharing remains debatable.[10] In monetary unions, financial risk sharing remains an essential channel for leveling out the effect of asymmetric shocks across regions.[11] Risk-sharing traditionally works through two main channels: cross-border lending to households and companies; and cross-border holdings of productive and financial assets.

In a monetary union like the euro area, which has no central fiscal authority, both channels should have contributed to containing the fallouts from economic shocks in member states. What we have experienced is the opposite: financial flows amplified the crisis when some euro area countries faced a sudden stop. This followed years of increasing cross-border lending and borrowing and excessive risk-taking, mainly through bank-based financial intermediation. When panic led to an abrupt reversal of financial flows and fragmentation of the euro area banking system, the central bank had to take over the role of the interbank market in providing liquidity to banks in stressed countries.

The Great Moderation masked the fault lines in the Economic and Monetary Union's financial architecture. The Great Recession revealed all the cracks, including the pernicious link between euro area banks and sovereigns. The sovereign debt crisis resulted in capital controls in two euro area countries, leading to a temporary reversal of financial integration in Europe.

This proves that expected benefits of risk sharing can turn sour *ex post*, for example if the composition of flows is too risky and too vulnerable to abrupt changes in international investor sentiment. The key policy-relevant question is, which institutions and rules are necessary for financial risk sharing to achieve all the benefits it has in theory?

Financial risk-sharing benefits and, more broadly, financial integration are deeply rooted in the soundness of institutions and policy rules. This is in line with the already mentioned empirical findings on the lasting growth effects of capital flows, which depend on institutional thresholds. Sound institutions and policy rules are necessary to guarantee clear definitions of property rights and procedures in case of financial stress, to ensure the stability of the domestic financial system through regulation, supervision and resolution frameworks, to mitigate the cost of cross-border and cross-currency transactions, and to create a level playing field for financial tax regimes. In addition, the benefits from financial integration will only materialise if underlying economic stability prevails.

The institutions and policy rules in question vary in their extent and reach, depending on whether one considers the national level, the euro area level or the global level. At the national level, for instance, the existence of a national currency guarantees that there is no exchange rate risk hampering capital flowing from one region to another; tax rules are usually applied uniformly across a nation, which prevents arbitrage; and the regimes for regulation, supervision and resolution are identical, at least for specific parts of the financial sector, such as banks, which strengthens depositors' confidence.

At the global level, financial stability arrangements naturally differ across countries. There has been significant progress in aligning global frameworks for regulation, supervision and resolution, but more still needs to be achieved. There is no global jurisdiction for cross-border and cross-currency transactions across countries and tax regimes differ widely from one country to another, offshore financial centers and non-cooperative jurisdictions being extreme cases. Last but not least, underlying economic conditions and policies widely differ across countries, which affect incentives for cross-border capital flows and for financial integration to deepen or weaken.

And at the euro area level, financial stability arrangements before the crisis were not in line with the requirements of monetary union. While Member States shared a single currency, there was no single framework for supervision and resolution. There was also a general lack of awareness of the risks that such a fragmented institutional framework could pose for area-wide financial stability. This led to a general misperception of financial risk, and short-term, uni-directional financial flows.

III. Strengthening the necessary institutions and policy rules is essential for the euro area to reap the full benefits of financial integration

The financial crisis of 2007–2009 and the sovereign debt crisis of 2011 were wake-up calls for our continent. They exposed the incompleteness of our monetary union, the fragility of our financial integration, and the limited scope for action of institutions other than the ECB.

In short, they strongly underscored the need to move to a genuine Economic and Monetary Union. Euro area leaders have since launched the Banking Union, to be complemented over time with the Capital Markets Union, to deepen financial integration within the euro area. The Banking Union will help strengthen cross-border lending to households and companies within the euro area. The Capital Markets Union aims to strengthen integration of capital markets within the area. This, in turn, will help strengthen cross-border holdings of productive and financial assets. The Banking Union and the Capital Markets Union involve the creation of new institutions and policy rules, which will help the euro area to reap the full benefits from financial risk-sharing.

Some of the key ingredients of the Banking Union are already in place: the Single Supervisory Mechanism was created in 2014, the same year as the Directive on Deposit Guarantee schemes was adopted, which harmonises the level of deposit protection and payout periods in the European Union. A Single Resolution Mechanism has been operational since 1 January 2016. It implements the EU-wide Bank Recovery and Resolution Directive in the euro area.

Banking Union, however, remains work in progress. Further steps are under discussion, such as a fiscal backstop for the Single Resolution Fund and the creation of a European Deposit Insurance Scheme. These aspects will no doubt remain high on the European policy agenda, because our continent needs to strengthen the integration of its banking and capital markets substantially in the absence of alternative risk-sharing mechanisms, at least for the time being.

To sum up, sound economic policies as well as policy rules and institutions that are necessary to oversee their implementation at a European level, remain a prerequisite for financial integration to support financial stability. They benefit not only to the euro area, but to the global economy at large.

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[1] See Matthieu Bussière, Julia Schmidt and Natacha Valla (2016), "International Financial Flows in the New Normal: Key Patterns (and Why We Should Care)," *CEPII Policy Brief*, 2016-10, CEPII research centre.

[2] See Caroline Van Rijckeghem and Beatrice Weder di Mauro (2014), "Deglobalization of Banking: The World is Getting Smaller," *CEPR Discussion Papers*, 10139.

[3] For instance, it was argued that a critical reading of the empirical literature lent some "qualified support to the view that developing countries can benefit from financial globalization, but with "many nuances"; see Ayhan Kose, Eswar Prasad, Kenneth S. Rogoff and Shang-Jin Wei (2006), "Financial Globalization: A Reappraisal", *NBER Working Paper No*. 12484.

[4] See Kose et al. (2009), op. cit.

[5] See Caballero, J. A. (2014), "Do surges in international capital inflows influence the likelihood of banking crises?" Economic Journal.

[6] See Hélène Rey (2013), "Dilemma not trilemma: The global financial cycle and monetary policy independence". In: Jackson Hole Economic Symposium 2013.

[7] According to the trilemma, in a financially integrated world, fixed exchange rates export the monetary policy of the centre country to the periphery. The corollary is that if there are free capital flows, it is possible to have independent monetary policies only by having the exchange rate float; and conversely, that floating exchange rates enable monetary policy independence (see e.g. Obstfeld and Taylor (2004)).

[8] See e.g. Olivier Jeanne and Anton Korinek (2010) "Excessive Volatility in Capital Flows: A Pigouvian Taxation Approach", *American Economic Review Papers & Proceedings* 100(2), pp. 403-407 and Emmanuel Farhi and Ivan Werning (2014), "Dilemma not Trilemma? Capital Controls and Exchange Rates with Volatile Capital Flows," *IMF Economic Review* 62, pp. 569-605.

[9] Under the IMF new institutional view, CFMs should not substitute for warranted macroeconomic adjustments. Circumstances which allow for CFMs on capital inflows include for example a situation in which the economy is overheating, the exchange rate is overvalued and reserves are at adequate levels. Similarly, CFMs could be applied on capital outflows if the economy is stagnating, FX exposures are high, and reserve levels are inadequate.

[10] In many studies gains are of second order of magnitude as financial integration enables a reduction of consumption volatility but does not affect output (see Nicolas Coeurdacier, Hélène Rey and Pablo Winant, 2015 "Financial Integration and Growth in a Risky World", *NBER Working Paper*, No. 21817).

[11] One estimate suggests that the standard deviation of income growth uncertainty is reduced through financial markets by as much as 35% across U.S. states (see Stefano G. Athanasoulis and Eric van Wincoop, (2001), "Risk Sharing Within The United States: What Do Financial Markets And Fiscal Federalism Accomplish?," *The Review of Economics and Statistics*, 83(4), pp. 688-698. According to a recent IMF paper, cross-country risk sharing in the euro area is not only more limited (roughly half that seen in existing federations), but also falls sharply in severe downturns. See "Fiscal Risk Sharing: New Evidence for the Euro Area", IMF Technical Background Note, September 2013. This is largely in line with recent evidence contained in the ECB's annual report on financial integration, which stresses that risk sharing in the euro area has increased with the introduction of the euro, but remains at relatively low levels. It also suggests that risk sharing is particularly fostered through various forms of equity holdings, underlining the importance of the capital markets union and its emphasis on equity markets. See ECB (2016), "Financial Integration in Europe", April 2016.