Philip R Lane: Globalisation and innovation in finance - policy challenges

Address by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the European Financial Forum, Dublin, 24 January 2017.

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I am delighted to have the opportunity to speak at today's European Financial Forum. The agenda for today's event is quite broad but globalisation and innovation are two primary themes that are set to recur throughout today's sessions. Of course, the forces of globalisation and technological disruption have wide-ranging economic, social and political implications but I will focus more narrowly on the analysis of these themes in the context of the financial sector and the challenges for financial regulators and central bankers.

I will first discuss financial globalisation before turning to financial innovation in the second part of this speech. While I discuss these topics sequentially, it is also clear that these forces interact. In one direction, information technology is a primary facilitator of financial globalisation. In the other direction, an integrated global financial system increases the potential rewards to financial innovation, in view of the importance of scale economies in the rollout of new technologies. In addition, internationally-diversified investors are an important source of risk-absorbing funding for innovating firms.1

Financial globalisation

In the aftermath of the global financial crisis, the nature of financial globalisation has shifted.2 International financial flows to and from advanced economies have been weaker than during the pre-crisis period, especially in relation to cross-border banking activity. In contrast, international financial flows to and from emerging economies have increased in importance, which is reinforced by the expanding share of emerging economies in global GDP.

Foreign direct investment (FDI) positions have continued to expand, in contrast to the portfolio equity, portfolio debt and non-portfolio debt categories. A striking pattern is that the recent expansion in FDI has been concentrated in positions vis-à-vis international financial centres, suggesting that the increased complexity of the corporate structures of multinational enterprises is playing an important role in determining the pattern and composition of direct investment flows.

More generally, the global intermediation role of international financial centres poses analytical challenges in understanding the implications of measured international financial flows for the real economies of individual countries. For instance, the role of international financial centres makes it trickier to assess the underlying interconnections between national macro-financial conditions, national macro-financial policies and the scale and composition of international financial flows. It also makes it more difficult to interpret measures of national economic performance, with indicators such as gross domestic product providing insufficient guidance for financially-globalised economies. For these reasons, it is vitally important to improve the quality and relevance of international financial data in order to gain a better understanding of the links between the ultimate holders and ultimate issuers of financial instruments.3 In particular, the international policy community needs to make further progress in implementing the recommendations of the G-20 Data Gaps Initiative (DGI).

The secular expansion of emerging economies both as an investment destination and as a source of funding for the advanced economies is a central factor in thinking about many of the
topics on the international financial agenda, including the nature and number of international currencies, the design of international financial safety nets and the operation and governance of global and regional official financial institutions.

In relation to the conduct of monetary policy, the global financial environment plays an important role in determining the financial conditions facing European firms and households, while the responses of global investors are central to the transmission mechanism for monetary policy operations. For instance, it is clear that medium- and long-term interest rates include a substantial common global component, with the net external purchases of euro-denominated bonds a basic channel by these rates are influenced by global investors.\footnote{4} In similar vein, the evidence indicates that the transmission of unconventional monetary policies also operates via the portfolio decisions of global investors. In particular, investors from outside the euro area have been significant counterparties in the ECB asset purchase programme, such that its effectiveness in rebalancing portfolios has in part worked through the allocation decisions of foreign investors.\footnote{5}

Symmetrically, adverse shifts in external financial conditions constitute a risk factor for the success of the ECB’s monetary strategy. The exposure of the euro area to fluctuations in global financial conditions helps to explain the flexible nature of the ECB’s asset purchase programme, as reflected in the scaling up of monthly purchases from €60 billion to €80 billion in March 2016 and the recent decision to return to a monthly volume of €60 billion from April 2017 onwards. This flexibility is also embedded in our forward guidance, with the introductory statement to the press conference following last week’s monetary policy meeting of the Governing Council specifying that:

“In particular, if the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, we stand ready to increase our asset purchase programme in terms of size and/or duration.”

More generally, the high degree of interconnectedness across currency areas makes it imperative that central banks actively cooperate in the sharing of information and analysis, so that monetary policy decisions are based on a shared understanding of current macro-financial conditions.\footnote{6}

Especially in view of Ireland’s status as an international financial centre, the Central Bank of Ireland is committed to playing its part in the analysis of international financial linkages. This includes publishing research on the characteristics of the Irish investment funds sector, which predominantly consists of intermediation structures that link foreign investors and foreign issuers.\footnote{7} It also includes giving due attention to global financial conditions in our assessment of risks to domestic financial stability. To this end, the Bank is allocating increased resources to the monitoring and analysis of global financial conditions, as part of our new financial stability directorate that is being established this year to consolidate and reinforce the Bank’s multifaceted work on financial stability.\footnote{8}

Disruptive innovation

Technological innovation is a second force driving structural changes in the international financial system. In particular, disruptive types of innovation that create new markets and products and carve out new categories of customers are especially powerful, relative to incremental forms of innovation that just seek to improve the quality or lower the cost of existing financial products.\footnote{9}

It is possible that segments of the financial sector could be arriving at a tipping point in terms of the impact of disruptive innovation. While it would be unwise to offer strong predictions as to the ultimate impact of any specific innovation, regulators and central bankers must be sufficiently
prepared to respond appropriately to a shifting financial services landscape.

In our regulatory work, technological development in the financial services sector makes us more interested than ever in seeing evidence of prudent business management. Strong governance, clear strategic planning and effective and embedded risk management are especially critical during phases of disruptive innovation.

Some of our key regulatory considerations include: (a) for authorisations, we need to strike the right balance between ensuring that firms seeking entry to the financial system meet our expectations, while at the same time being to open to innovation; (b) for regulated firms, we are vigilant about shifting business models and emerging risks – including ensuring that prudential and consumer protection requirements are appropriate for new business models; (c) our orderly resolution regimes are being adjusted to enable the financial system to absorb the failure of individual firms as others grow and prosper; and (d) we are strengthening international cooperation arrangements necessary to be able to effectively regulate in a digital environment that may have little regard for national borders or jurisdictional reach.

Disruptive innovation and the global unbundling of traditional financial services models in banking, insurance, and funds management can also have implications for financial stability. International consolidation in the financial services market to maximise the scalability benefits of new technologies may create larger firms that are more difficult to resolve. Greater specialisation may also foster the growth of mono-line firms that are more exposed to sectoral shocks. It is also important to assess the implications of new types of settlement systems and digital currencies for the role of central banks in the domestic and international monetary systems, including the pros and cons of digital base monies supplied by central banks.

Conclusions

In summary, the dual forces of globalisation and innovation are high on the research and policy agendas for financial regulators and central bankers. An immediate challenge relates to the post-Brexit reconfiguration of the European financial sector. In managing the transition to the new post-Brexit regime, it is essential for policymakers to take a global perspective in view of the importance of non-European investors and financial intermediaries to the functioning of the European financial system. Equally, financial innovators will be looking for clarity about the new regulatory and trading arrangements between the UK and the EU, since uncertainty about institutional frameworks is an obvious inhibitor of investment plans.

Let me conclude by thanking the organisers of the European Financial Forum. The agenda and lineup of speakers for the rest of today looks fascinating.

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