

20100219 ECB: Globalisation, international financial integration and the financial crisis - The future of European and international financial market regulation and supervision (Speech by José Manuel González-Páramo, Member of the Executive Board)

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Introduction

I would like to thank the Institute of International and European Affairs for organising this conference and for giving me the opportunity to speak in front of such a distinguished audience. I am particularly glad to be able to participate in the Institute's series of speeches dedicated to the theme of "Fixing finance". Both the prominence of the subject and the high quality of past contributions have made this series of speeches an important source of interesting ideas and proposals on how to render our financial systems more stable and resilient.

Following the nature and objective of the series, I will dedicate part of my address to the issue of the future framework for European and international financial market supervision and, in particular, to the role of the ECB in macroprudential supervision in the European Union, but first let me briefly discuss the relationship between international financial integration and the financial crisis.

International financial integration and the financial crisis

Over the past decade or so, financial crises seem to have become more frequent and perhaps more disruptive than in the past. They also seem to propagate more rapidly. This experience has spurred intense interest among academics and policy-makers in understanding the link between financial integration and crises, and in better assessing the merits of financial integration in general.

The debate on the benefits of international financial integration is certainly not uncontroversial:

-One extreme opinion sustains that integrated financial systems improve the allocation of productive resources, foster entrepreneurship and innovation, enhance market discipline, and help countries to insure against macroeconomic fluctuations.

-At the other extreme, it is argued that the free flow of capital widens the wealth gap between rich and poor countries and exposes domestic financial systems to the risk of instability.

More recently, the financial crisis of 2007-08 and its aftermath have shown that increased geographical interconnection among financial markets and the deepening of cross-market integration, when coupled with the under-regulation of securitisation and other banking activities as well as with significant complexity in the design of financial instruments, may contribute to undermine market efficiency, fuel systemic risk and exacerbate the cross-border transmission of financial shocks.

Pros and cons of financial integration

In response to the crisis, a debate in policy and academic circles on how to enhance the resilience of the global financial system has gained momentum, while retaining the benefits of free, integrated, and competitive financial markets. Indeed, it is important not to forget that financial integration can potentially yield many benefits to our economies, particularly by rendering them more stable and resilient.

Indeed, one key channel through which financial integration improves the resilience of the global financial system is risk sharing.

Academic research has established beyond doubt that financial openness enhances both consumption and income risk-sharing, and reduces volatility of consumption growth. The same is true for banking integration, which has been shown to lead to more synchronised business cycles (as measured by GDP, employment, and income growth) at the country level, the evidence of which stems from both Europe and the US.

In general, improved risk-sharing opportunities allow economic agents to smooth their consumption and investment patterns better over time. And while this is mostly true for developing countries, the risk-sharing provided by financial integration and increased foreign capital flows have also benefited relatively developed countries, for which the integration of the central and east European countries since 1989 has served as a prime example.

Besides, improved risk-sharing enhances in turn the ability of countries to specialize in their most productive sectors, leading to increased economic efficiency. Furthermore, pre-crisis research had suggested that the cross-border diversification of large banks improves the soundness of the banking system by making individual bank failures less likely. On a related issue, we should recall that a primary role of interbank markets is to provide banks with an efficient risk-sharing tool.

Another channel through which financial integration improves macroeconomic stability is allocative efficiency and economic diversification. Cross-border banking, for instance, tends to improve overall economic performance by ensuring that productive capital is channelled towards the most efficient firms, thereby reducing the risk of crises stemming from the mispricing of investment risk.

Financial integration in general assists domestic financial systems in allocating resources across industrial sectors in a way which improves the overall diversification of the economy and lowers its volatility. As a result, an optimally diversified economy is less prone to recessions, and so its real sector responds less to the same shock than an economy which relies on just a few sectors. While not directly, this result gives some grounds to one popular claim these days, namely that countries with excessively reliance on specific sectors (whether the construction sector or the financial industry) may suffer more during large-scale economic crises.

So much about the stabilising effects of financial integration. However, the recent crisis has also sharpened our understanding of the destabilising potential of financial integration. Two separate questions beg for an answer in this regard:

-Does financial integration increase the likelihood of a financial crisis?

-Does integration exacerbate the impact of a financial crisis?

The crisis has added to our knowledge of the circumstances under which the answer to both questions is "yes":

First, while financial integration is not a destabilizing force per se, stability risks may arise if the driving forces underlying stronger international financial integration reflect global economic imbalances. It is reasonable to argue that the pre-crisis boom in US real estate and securitisation markets reflected to some extent high foreign demand for safe US assets resulting from "excess world savings" in the context of persistent global imbalances.

Consequently, foreign asset demand not only pushed down the US risk-free interest rate, but also compressed the risk premia on risky assets. The low cost of financing fostered in turn an increase in the level of leverage of the domestic financial sector which exacerbated systemic risk. This interpretation of the events makes an important point, namely that increasing the stability of the global financial system should not be done by pushing back financial globalization, but by first addressing the problem of the global imbalances.

A second example of the nuances involved in assessing the destabilising potential of financial integration is banking integration. While in principle it is associated with enhanced efficiency, certain circumstances, such as regulatory arbitrage and lack of transparency in transactions, can exacerbate information problems associated with cross-border banking and lead to misaligned incentives, excessive risk-taking, and underestimating the social cost of contagion.

It has also been observed that, while banking integration benefits efficient firms through lower cost of external finance, very rapid integration induces firms to take on excessive leverage, exacerbating the effect of financial crises on the corporate sector.

Finally, in the context of this crisis, cross-border banking integration has been associated with the transmission of financial distress from banks' balance sheets to the corporate sector of countries which were not the origins of the shock. However, this effect has mostly worked through banks which relied predominantly on wholesale funding, rather than on a strong deposit base. And so again, we are left to ponder over a subtle point: it is not integration per se that is to blame for financial instability and its impact on the real economy, but lack of transparency, wrong

incentives, sub-optimal regulation, and certain flawed banking business models - all of which may, but certainly must not necessarily accompany financial integration.

Given this picture, it is clear that the challenge of the day is how to strengthen financial stability without reducing long-term growth. The current academic and policy debate has already given us some guidance as to which measures could serve this purpose best.

Among the critical issues under consideration, I would like to mention: (1) shortening securitization chains and making them more transparent; (2) promoting greater standardisation of the various credit risk transfer instruments; (3) moving over-the-counter derivatives trading – in particular that of credit default swap markets – to central clearing counterparties; (4) demanding greater transparency of the assets, liquidity and leverage of non-bank financial intermediaries; and (5) improving frameworks for the resolution and re-capitalisation of large cross-border financial groups.

The ongoing reforms of supervisory and regulatory institutions, both at the European and international level, are one vital step in this direction.

Policy responses to increased international financial integration

In response to the extraordinary global impact of the financial crisis, the G20 has forcefully taken the leadership in advancing the agenda for reforming the international regulatory and supervisory framework. In an unprecedented way, the G20 has become the global forum for international coordination and has agreed on a broad set of measures to be followed by national authorities and international standard setters.

In order to further advance the process, the newly established Financial Stability Board (FSB) has been entrusted with the task of overseeing concrete regulatory steps and monitoring the implementation of the reform agenda. The participation of the main international fora and institutions - the International Monetary Fund (IMF), the Bank of International Settlements (BIS) and the International Organization of Securities Commissions (IOSCO) - in the FSB is also proving instrumental in ensuring cross-sectoral coordination.

International coordination cannot be dispensed with when dealing with the additional layers of complexity posed by the modern integrated financial system. Indeed, the decision to switch towards the enlarged composition of the G20 (as opposed to the G7) and the parallel broader country representation in the FSB are themselves an acknowledgement of the forces of globalisation and financial integration. It can be safely argued that the current framework for decision-making at a global level explicitly recognises the fundamental role played by new countries and markets in the global economy as well as the existence of a complex, if somewhat fragile, web of interconnections between economies, markets and institutions.

The challenges posed by a globally integrated financial system and the ensuing need for higher international coordination are therefore well recognised. The establishment of colleges of supervisors for all major cross-border financial institutions is a clear instance of enhanced co-operation among international authorities. In order to ensure international harmonisation, the FSB is also developing a system of peer reviews among member countries. These will comprise both single-country and thematic reviews to assess progress and convergence in the implementation of international financial standards and of policies agreed in the FSB.

Let me now turn to the thrust of the banking reform – in itself a major overhaul of the prudential framework – put forward by the Basel Committee of Banking Supervision (BCBS), under the aegis of the G20. The Basel Committee has agreed on a package of measures which aim at increasing the resilience, safety and soundness of the banking system in a way consistent with long-term economic growth, without hampering the functioning of the market and the pending economic recovery.

-First and foremost, the Basel Committee proposals will significantly raise quality, quantity, consistency and transparency of capital, to ensure permanent higher capacity to withstand losses. A common international definition of capital and appropriate disclosure of its components will contribute to increased transparency and comparability.

-Second, in addition to a revised treatment of the trading book and securitisations, capital requirements for counterparty credit risk exposures arising from derivatives, repos and securities financing activities will be introduced, as well as parallel incentives for the central clearing of over-

the-counter derivatives.

-Third, a non risk-based leverage ratio will supplement risk-based capital requirements and help to curb excessive balance sheet growth.

-Fourth, a framework of countercyclical capital buffers above the minimum requirement coupled with more forward-looking provisioning rules will contribute to dampen rather than amplify the financial and credit cycles: banks will adjust their capital in such a way that capital is built up in good times and drawn upon in times of stress.

-Fifth, a harmonised treatment for liquidity risk will be introduced, requiring banks to hold sufficient high-quality liquid assets to withstand episodes of financial stress.

These proposals, currently under consultation, will be the object of an extensive assessment as regard their impact on both the banking sector and the broader economy. This assessment should result in appropriately calibrated global standards, which will promote a more sustainable trade-off between financial stability and balanced long-term growth.

Beyond the prudential framework, the relevant organisations are actively conducting work in other crucial areas where co-ordination remains key, most notably: (1) the development of a framework for macro-prudential supervision, (2) devising effective mechanisms to address the moral hazard problem and the risks posed by "too big to fail" institutions, and (3) legal regimes to allow an ordered resolution of complex financial institutions.

The global financial crisis requires a global response and the recent initiatives I just mentioned are clear illustrations of this. At the same time, I believe that in Europe we have to go much further in our response, not in the least because the European countries are much more interlinked with each other than with the rest of the world. Economically, financially and institutionally the setting is indeed very different, since it is most clearly epitomised by the presence of the Single Market and the single currency.

Fortunately, policy makers in Europe quickly realised that there was an urgent need for quick, bold and coordinated responses. I want to single out two very important initiatives in this respect:

-The adoption of the ECOFIN roadmap of 20 October 2009 on financial supervision, stability and regulation.

-The proposals for a new supervisory framework in the EU based on the recommendations by the so-called de Larosière Group which were published in September last year.

The ECOFIN roadmap is an ambitious set of policy priorities adopted by the Council in the wake of the financial crisis, with the aim of strengthening financial supervision and regulation in the EU. The international initiatives I mentioned earlier fit well into the framework implied by the roadmap, but, at the same time, the latter goes significantly further. For example, regarding the issue of the colleges of supervisors that I mentioned earlier, the Committee of European Banking Supervisors (CEBS) is additionally developing common operational guidelines and a common risk methodology. Indeed, in a single banking market, a common approach is a necessity to avoid inconsistencies and regulatory arbitrage.

A mandate for financial stability for central banks

A very important component of the roadmap is the revision of the EU supervisory framework covering both the micro and macro dimensions. The extraordinary nature and consequences of the global financial crisis have demonstrated the need for upgrading the regulatory framework. A broad consensus has arisen in favour of a macro-prudential orientation of supervision.

Macro-prudential oversight focuses on the financial system as a whole and involves the monitoring, assessment and mitigation of systemic risk. Crucially, it recognises that systemic risk is partly endogenous as it depends on the collective behaviour of financial institutions and their inter-connectedness, as well as the interaction between financial markets and the macro-economy. Macro-prudential policies aim to mitigate the build up of financial imbalances and ensure that the financial system is able to withstand their unwinding and be resilient to shocks.

In the EU, the European Systemic Risk Board (ESRB) will be in charge of macro-prudential surveillance. Its task will be to identify and assess risks to the stability of the EU financial system and issue risk warnings when the identified risks appear to be significant. When appropriate, the ESRB could complement its risk warnings with policy recommendations for remedial action.

As stressed by the de Larosière Group, central banks are especially well suited to take up the main

responsibility for macro-prudential supervision because of their expertise and analytical capabilities in the fields of monetary and financial stability analysis, and because of their closeness to the money and financial markets.

The tight interlinkages between the financial system and the macro-economy provide a further rationale for entrusting the central banks with the responsibility for macro-prudential analysis and the formulation of relevant policy recommendations. Macro-prudential policies will help reduce the contribution to pro-cyclicality of various factors in the financial system. Since policies will involve regulatory and supervisory action to a considerable extent, they may take the form of general guidelines or concrete recommendations relating to the calibration of prudential tools.

In the specific case of the EU, the ECB will provide analytical, statistical, administrative and logistical support to the ESRB. In particular, the ECB will assist the ESRB in the development and collection of new statistical data. The ECB will also assist the ESRB by developing and maintaining new analytical tools and methodologies for the identification and assessment of systemic risks and the issuance of risk warnings. This task poses significant challenges because it requires special skills and the further development of analytical tools. Models must be developed to help structure and analyse the vast amount of information collected for risk assessment. As financial stability and macro-prudential analyses are at a relatively early stage, it is advisable to employ a multiplicity of approaches.

It goes without saying that the creation of the ESRB does not change in any manner the allocation of responsibilities among policy-makers enshrined in the Treaty, notably the unambiguous establishment of the maintenance of price stability as the primary objective of the ECB's monetary policy. At the same time, the assignment of specific tasks related to the functioning of the ESRB to the ECB actually enhances its ability to fulfill the task of contributing to the maintenance of financial stability, as foreseen by the Treaty.

Conclusions

The current financial crisis has spread across the world at an unusual speed and with surprisingly strong consequences. The fact that the tensions originating from a relatively small segment of the international financial market (the US market for sub-prime mortgage loans) evolved over time into a global crisis of a magnitude unseen in decades – wreaking havoc on a number of economies and the lives of millions – may deceive some into thinking that worldwide financial integration has gone too far and that we would better off under financial autarchy.

It is therefore worthwhile to recall what the benefits of financial integration are, especially in Europe. Integrated financial markets help to realise the full economic potential by increasing competition and expanding markets. This results in lower intermediation costs and a more efficient allocation of capital, which in turn raises the potential for increased economic growth.

For those European Member States which have gone even further by adopting the euro as the single currency, there are added benefits in terms of price transparency, lower interest rates, reduced transaction costs and the elimination of exchange rate fluctuations. These benefits are very substantial.

At the same time, the financial crisis has been a rough reminder that, although financial integration improves the access to financial markets and the opportunities for risk diversification, it may also increase the scope for financial contagion across countries. It is therefore paramount that the financial stability arrangements keep pace with the degree of financial integration. Such arrangements should be particularly ambitious in the EU and the euro area, which are characterised by a very high degree of financial integration. This is why it is important that we fully and quickly implement the reforms of the European and international supervisory and regulatory framework which are needed to enhance the robustness of our financial systems.

