Adapting to Financial Globalisation

Edited by
Morten Balling, Eduard H. Hochreiter and Elizabeth Hennessy

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Introduction

Morten Balling

The papers in this volume were all presented at a conference in Vienna at the end of April 2000. The common theme of the papers is financial globalisation and the ways in which banks, supervisory authorities and central banks should deal with it. Following the SUERF tradition, the colloquium was a combination of plenary sessions and commission discussions.

The first five papers in the book are contributions to plenary sessions. Papers 6 to 15 are contributions to the work in the commissions arranged in alphabetical order according to the author's surname.

Paper no. 1 by *Andrew Crockett*, General Manager of the BIS, deals with the links between financial and monetary (in)stability. One of the reasons why the financial sector is prone to instability is that fundamental value is extremely hard to assess. Return expectations are subject to powerful waves of optimism and pessimism, greed and fear. A second reason is that excess supply does not necessarily put immediate downward pressure on prices and profits. Lending booms can for a while sustain the development of imbalances. A third reason is that fragile balance sheet structures can intensify instability. Finally, safety nets designed for prudential reasons can weaken market discipline. Recently anti-inflation policies in Europe have in general been successful. The combination of a liberalised financial system and a fiat standard with monetary rules defined exclusively in terms of inflation is, however, not a sufficient condition for financial stability. Further research is needed in order to find appropriate anchors for financial and monetary stability. The Financial Stability Forum will be involved in research, which can increase the understanding of these crucial questions.

Paper no. 2 by Advisor *Jacques de Larosière*, Paribas, gives a survey of mergers and other strategic moves in the financial sectors of Europe, which have fundamentally changed the structure of the European banking sector. The author compares Europe with the US and observes that there are still many more banks in the US than in Europe, although the two zones are comparable in terms both of GDP and population. The average bank profitability is, however, much higher in the US than in the euro zone. Mergers in the European banking sector are classified as domestic transactions and cross-border transactions. In the 1990s one could observe relatively few very large domestic transactions and a larger amount of small cross-border transactions. Barriers to further restructurings still exist. The author mentions the absence of a European corporate law and takeover rules. The key to future success of European banks is adaptability. In this context, attention has to be paid to the development of the internet applications in financial activities and their impact on bank strategies.

Paper no. 3 by the Governor of the Austrian Central Bank, Dr *Klaus Liebscher,* focuses on central banking in the euro area, in particular in relation to safeguarding systemic stability. The author points out that the EMU intensifies competition in financial markets. While this has beneficial effects on productivity and efficiency, it may also have a risk-increasing effect. Contagion risk as well as the risk of eroding profit margins raise the vulnerability of financial institutions. It is the evaluation of the Governor that the principle of subsidiarity has worked well also in financial regulation and supervision. The ECB has, however, a consultative role in prudential supervision. The euro stands every chance of becoming a currency of global importance. In Central and Eastern Europe it is very likely that the euro will play a key role in the future.

The basis for paper no. 4 by *Claes Norgren*, Director General of the Swedish Financial Supervisory Authority, is the consultative 1999 document on a New Capital Adequacy Framework written by the Basel Committee on Banking Supervision. The new framework is supposed to replace the 1988 Basel Accord on measuring capital adequacy and the minimum standard to be achieved. Implementation of the new framework will represent a move from standardised risk weight calculations to a more differentiated approach. Information from external ratings and internal rating systems may be used to achieve a certain risk differentation.

In paper no. 5 by *Tommaso Padoa-Schioppa*, member of the board of the European Central Bank (ECB), the author attempts to describe plausible characteristics of the European banking landscape after the integrating effect of the euro has been effective for some years. The author points out that the speed of integration so far has been much higher in wholesale financial markets than in retail markets. National and cultural obstacles can be expected to slow down the integration in retail markets for some years to come.

Paper no. 6 deals with fiscal discipline and exchange rate regimes. The authors, *Enrique Alberola* and *Luis Molina,* show in their paper that a particular version of fixed exchange rate regimes, the currency boards, may effectively restrain fiscal policy by ruling out fiscal seignoriage. The authors apply comprehensive data from twenty-four emerging and transition countries. The attraction of currency boards is related to the perception in the market of the high commitment to the peg that the board provides.

Paper no. 7 by *Josef Christl* and *Thomas Spanel* gives an outline and evaluation of a model of transfer risk analysis which has been used by an international commercial bank for managing country risk. From a pragmatic point of view, the question is whether the symptoms of crisis can be detected sufficiently in advance to allow for pre-emptive measures to be adapted. A rating model is applied to the recent crisis in Thailand, Brazil and Russia. It turns out that the model captured the crisis in Thailand and Russia very well, while the exchange rate crisis of Brazil was not really perceptible.

In paper no. 8, *B. Gerard Dages, Linda Goldberg* and *Daniel Kinney* apply bank-specific data on lending by domestically- and foreign-owned banks in Argentina and Mexico in order to analyse differences in loan growth rates and volatility of lending. They find that bank health, and not ownership *per se*, is the critical element in the growth, volatility and cyclicality of bank credit. Diversity in ownership appears, however, to contribute to greater stability of credit in times of crisis and domestic financial system weakness.

US financial history provides a number of examples of financial crisis from which Europeans can learn. In paper no. 9 *E. Philip Davis* covers the 1929–33 stock market crash and banking crisis, the Continental Illinois case (1984), the US thrifts case (1979–89), the banking crisis in Texas (1985–89), the collapse of the junk bond market (1989) and the Russia/LTCM Crisis (1998). In the crises described too big to fail aspects, real estate lending booms and rising corporate leverage occurred in different combinations. In spite of all the institutional differences between US and Europe, there are lessons to be learned for people involved in designing an appropriate regulatory structure in Europe.

Paper no. 10 deals with the strategies developed by Spanish banks for adapting to financial globalisation. *Ignacio Fuentes* and *Teresa Sastre* compare by means of an empirical model bank interest rates of merged firms with those of non-merged ones. The analysis seems to indicate that mergers and takeovers do not *per se* give rise to generally differentiated forms of behaviour. An analysis in the paper of the effects of mergers on the profit-generating capacity and the level of efficiency does not provide clear answers. The remarkable growth of Spanish mutual funds has, however, significantly reduced the growth rate of traditional bank deposits. Spanish banks have expanded their activity abroad, in particular by investing in subsidiaries and branches in Latin America.

In paper no. 11 *Hans Geiger* focuses on payment intermediation in a global economy. The subject is important both for the economy as a whole and for the future of the banking industry. Different types of market transactions are connected with risks, which can be handled in different ways. Banks have over the years developed techniques which can protect the parties involved in international payment transactions. New technology is causing far-reaching changes in payment systems.

Deregulation and the emergence of technology have created highly competitive market conditions which have had a critical impact on consumer behaviour in relation to financial services. In paper no. 12, *Barry Howcroft* explains that banks have to respond strategically to these changes. The author applies a model in which the consumer behaviour is taken as being generally rational, and the choice environment is simplified by heuristics. Bank customers are classified according to their involvement and confidence. Knowledge of financial products varies considerably among the customers and banks must adapt their marketing and information to the ability of the customers to understand the characteristics of the products.

In paper no. 13 *Kenneth N. Kuttner* and *Adam S. Posen* analyse to what extent domestic inflation and interest rate surprises – fluctuations unexplained by past history and the systematic response of policy – contribute to short-run volatility in G3 exchange rates. They point out that the yen/dollar exchange rate has consistently shown significantly greater volatility than either of the other bilateral G3 exchange rates, and that the DM/dollar exchange rate volatility has gradually declined since the late 1970s. They relate the last observation to what they call increasing institutional transparency from the three successive US Federal Reserve chairmen: Burns, Volcker and Greenspan. The behaviour of the exchange rates in relation to the yen is considered to be consistent with decreasing transparency and increasingly unsystematic monetary policy responses of the Bank of Japan. Their investigations support the belief that monetary policy transparency matters for exchange rate volatility.

Financial supervision is organised in different ways in the EU countries. In some of the countries monetary policy and banking supervisory functions are combined; in other countries they are separated. In paper no. 14 *Karel Lannoo* discusses what kind of challenges these structural differences pose to the authorities. In the view of the author, the established systems for coordination and regular exchange of information among the national supervisors are insufficient given the degree of market integration. He recommends that a European Forum of Financial Supervisors should be established. Monitoring of financial stability should take place in an institution set up to observe systemic risk, and steps should be taken to create an EU Securities Committee.

The cost-to-income ratio and its dispersion is often used as an indicator of efficiency in the European banking industry. In paper no. 15, which was awarded the Marjolin Prize 2000 at the colloquium, *Peter Van Dijcke* analyses comprehensive bank account data from the EU countries in order to go deeper into the impact of globalisation on efficiency. The regression model applied tends to signal that changes in the composition of bank income and overhead has on average a small impact. The findings seem to confirm that changing scale and scope has a limited impact on the cost-to-income ratio. By using the available inputs efficiently in order to generate a given output level the direct impact on the ratio itself is much larger. The author warns against simple benchmarking according to the cost-to-income ratio because banks may produce different output mixes that have different costs of production. The bank consolidation process which has taken place in Europe in recent years has contributed to the reduction of the cost-to-income ratio but at a different pace across individual banks and across EU countries.

1 In search of anchors for financial and monetary stability*

Andrew Crockett

It was in the seemingly distant 1996 that Alan Greenspan coined the famous phrase, 'irrational exuberance'. He was not just making a passing remark. He was asking a question. His words encapsulated the dilemma of whether, and if so how, monetary policy should respond to asset prices. In fact, his public utterance *was* a response. The question has now become a familiar, if largely unanswered, one for central bankers.

Meanwhile, asset prices have moved higher and their volatility has increased. Far from discouraging investors, this seems merely to have increased the fascination of the equity market. TV stations devoted to the market, like CNBC, have enormously increased their viewership. The 'analysis' offered by their commentators resembles nothing so much as that of hyperactive sports announcers. Viewers are sports junkies with the added thrill of a bet on every twist in the action.

These large asset price swings are themselves a palpable manifestation of the increased financial instability experienced around the world since at least the 1980s. The issue of how to deal with instability has quickly forced its way to the top of the international policy agenda. Just as policy makers appeared to be emerging victorious from one exhausting battle, that against inflation, another equally challenging front was opening up. Lower inflation, it appeared, had not by itself yielded the peace dividend of a more stable financial environment.

Today, I will explore the conjecture that the link between these two developments is less coincidental than it might seem at first sight. In order to elaborate on this proposition, let me first briefly describe the anatomy of financial instability. I will then discuss the changes in the financial sphere that have led to the observed greater instability before moving on to examine the link with the monetary sphere in a historical perspective. I will finally raise some policy questions emerging from the analysis.

* Paper presented at 22nd SUERF Colloquium, Vienna, 27–29 April 2000.

The anatomy of financial instability

The term 'financial instability' is commonly used to refer to two types of phenomenon: large movements in asset prices and financial distress of institutions. The two are closely linked.

The movements in asset prices that raise concern are not so much those crystallised in short-term volatility. Unless extreme and a source of strains on markets or institutions, day-to-day volatility is part of the physiology of well-functioning markets. Rather, it is those medium-term swings that take prices far away from sustainable values; what economists term their 'fundamental' values. Such misalignments, when they finally reverse, typically do so suddenly and violently, in a 'crash'. In the process, they raise short-term volatility to pathological levels. This may result in some casualties. But the major casualties follow once the reversal continues, usually in a prolonged and painful phase.

Distress among financial institutions can occur without price misalignments. In this case, however, it tends to be localised and the result of firm-specific factors. Poor management is the most usual cause. The main policy concern is systemic, not individual, distress, when large portions of the financial system are affected. Systemic distress can arise from the spreading of difficulties from individual institutions or market segments. But more often than not it stems from exposures to a common factor. Asset price misalignments are probably the most typical example of such common factors.

We care about financial instability because it is wasteful. Asset price misalignments would not matter if economic agents saw through them and discounted them. But often they do not. The misalignments can profoundly affect consumption and expenditure decisions. They impinge on perceptions of wealth and investment returns as well as on external financing constraints. Higher equity and real estate prices, for instance, act as a magnet for capital, and make it easier for borrowers to access external funds. Misalignments result in misallocation of resources across sectors and over time. *Across sectors,* because capital is sucked away from those where prices are relatively more sluggish towards those where they are more buoyant. Just think, for example, of the equity buy-backs in the 'old economy' as IPOs surge in the 'new economy' or of the construction booms that accompany soaring property prices. *Over time,* because if sufficiently pervasive, the misalignments result in aggregate over-investment or over-consumption, well in excess of permanent income. Once they reverse, the backlash is inevitable. And it is all the more powerful if the ability of markets and institutions to intermediate funds and generate credit is severely impaired. Hence the broader financial crises that go hand in hand with the most severe economic recessions.

Recent history provides numerous examples of the processes just described. In some cases the damage has been contained, as with the stock market crash of 1987. In others it has been more pervasive, as with the